SCS Agency
Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Alpert | Analyst: Garnier | Bill Number: SB 1496

Related Bills: See Legislative History | Telephone: 845-5322 | Amended Date: 4-20-98

Attorney: Doug Bramhall | Sponsor: ______

SUBJECT: Conformity Act of 1998

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _________.

_____ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO ________________________.

_____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ___________ STILL APPLIES.

__X__ OTHER - See comments below.

SUMMARY OF BILL AND AMENDMENT

The Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), in general, conform to the Internal Revenue Code (IRC) either by incorporating the IRC by reference as of a "specified date" or by stand alone language which mirrors the federal provision. California law is conformed to the IRC as of January 1, 1997, unless a specific provision provides otherwise. This bill would change the specified date from January 1, 1997, to January 1, 1998, for taxable and income years beginning on or after January 1, 1998. Changing the specified date automatically conforms to all changes from January 1, 1997, through December 31, 1997, to IRC sections that have been previously incorporated by reference. Thus, California law would conform to most of the changes made to the federal income tax by the Taxpayers Relief Act of 1997.

This bill also would make numerous changes to specifically not conform or modify certain items in the IRC. Additionally, numerous technical changes regarding cross references and the deletion of unnecessary language that was used to conform to federal law changes subsequent to January 1, 1997, and prior to January 1, 1998, are being made by this bill.

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Board Position:	Agency Secretary Position:	**GOVERNOR'S OFFICE USE**
____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR ____X____ PENDING	____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR DEFER TO	Position Approved ____ Position Disapprove____ Position Noted
Department/Legislative Director G. Alan Hunter 5/8/98	Agency Secretary Date	By:

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The changes that would be made to California tax law by this bill, as discussed in this analysis, are as follows:

EFFECTIVE DATE

Unless otherwise specified this bill would apply to taxable and income years beginning on or after January 1, 1998.

BACKGROUND

As stated above, the Revenue and Taxation Code (R&TC) conforms to various provisions of the IRC as it read on January 1, 1997. Subsequent to January 1, 1997, two bills have been enacted into law that materially affect the IRC. They are:

BALANCED BUDGET ACT OF 1997 (BBA of 1997)
TAXPAYER RELIEF ACT OF 1997 (TRA of 1997)

This bill (and analysis) generally addresses the changes made by the above federal acts that were not conformed to prior to this bill.

LEGISLATIVE HISTORY

SB 455 (Stats, 1997, Ch. 611)

SPECIFIC FINDINGS

1. Creation of Medicare+Choice Medical Savings Accounts.

Under present and prior **federal and state law**, the value of Medicare coverage and benefits is not includible in gross income.

Within limits, contributions to a medical savings account (MSA) are deductible in determining adjusted gross income (AGI) if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. The number of MSAs which can be established is subject to a cap. Under prior federal and current state law, individuals covered under Medicare were not eligible to have an MSA.

Earnings on amounts in an MSA are not currently includible in income. Distributions from an MSA for medical expenses of the MSA account holder and his or her spouse or dependents are not includible in income. For this purpose, medical expenses are defined as under the itemized deduction for medical expenses, except that medical expenses do not include any insurance premiums other than premiums for long-term care insurance, continuation coverage (so-called “COBRA coverage”), or premiums for coverage while an individual is receiving unemployment compensation. Distributions not used for medical expenses are subject to an additional 15% tax unless the distribution is made after age 65, or as a result of death or disability.

Prior to 1997, there were no tax provisions for Medicare+Choice medical savings accounts (Medicare+Choice MSAs). The **BBA of 1997** created Medicare+Choice MSAs for federal purposes.

In General

Under the **BBA of 1997**, individuals who are eligible for Medicare are permitted to choose either the traditional Medicare program or a Medicare+Choice MSA plan. Individuals who are eligible for Medicare are not eligible for an MSA that is not a Medicare+Choice MSA. To the extent an individual chooses such a plan, the Secretary of Health and Human Services makes a specified contribution directly into a Medicare+Choice MSA designated by such individual. Only contributions by the Secretary of Health and Human Services can be made to a Medicare+Choice MSA and such contributions are not included in the taxable income of the Medicare+Choice MSA holder. Income earned on amounts held in a Medicare+Choice MSA are not currently includible in taxable income. Withdrawals from a Medicare+Choice MSA are excludable from taxable income if used for the qualified medical expenses of the Medicare+Choice MSA holder. Medical expenses of the account holder's spouse or dependents are <u>not</u> treated as qualified medical expenses. Withdrawals from a Medicare+Choice MSA that are not used for the qualified medical expenses of the account holder are includible in income and may be subject to an additional tax (described below).

Definition of Medicare+Choice MSAs.

In general, a Medicare+Choice MSA is an MSA that is designated as Medicare+Choice MSA and to which contributions can be made only by the Secretary of Health and Human Services. Medicare+Choice MSAs are not taken into account for purposes of the cap on non-Medicare+Choice MSAs, nor are they subject to that cap. Thus, a Medicare+Choice MSA is a tax-exempt trust (or a custodial account) created exclusively for the purpose of paying the qualified medical expenses of the account holder that meets requirements similar to those applicable to IRAs. The trustee of a Medicare+Choice MSA can be a bank, insurance company, or other person that demonstrates to the satisfaction of the Secretary of the Treasury that the manner in which such person will administer the trust will be consistent with applicable requirements.

A Medicare+Choice MSA trustee is required to make such reports as may be required by the Secretary of the Treasury. A $50 penalty is imposed for each failure to file without reasonable cause.

Taxation of Distributions from a Medicare+Choice MSA.

Distributions from a Medicare+Choice MSA that are used to pay the qualified medical expenses of the account holder are excludable from taxable income regardless of whether the account holder is enrolled in the Medicare+Choice MSA plan at the time of the distribution. Under the provision, medical expenses of the account holder's spouse or dependents are not treated as qualified medical expenses. Qualified medical expenses are defined as under the rules relating to the itemized deduction for medical expenses. However, for this purpose, qualified medical expenses do not include any insurance premiums other than premiums for long-term care insurance, continuation insurance (so-called “COBRA coverage”), or premiums for coverage while an individual is receiving unemployment compensation. Distributions from a Medicare+Choice MSA that are excludable from gross income under the provision cannot be taken into account for purposes of the itemized deduction for medical expenses.

Distributions for purposes other than qualified medical expenses are includible in taxable income. An additional tax of 50% applies to the extent the total distributions for purposes other than qualified medical expenses in a taxable year exceed the amount by which the value of the Medicare+Choice MSA as of December 31 of the preceding year exceeds 60% of the deductible of the plan under which the individual is covered on January 1 of the current year. The additional tax does not apply to distributions on account of the disability or death of the account holder.

Following is an example of how the amount available to be withdrawn from a Medicare+Choice MSA without penalty is calculated. The numbers are provided for illustrative purposes only.

	Year 1	Year 2	Year 3	Year 4
1. Deductible...............	$3,000	$3,000	$3,000	$3,000
2. 60% of deductible........	1,800	1,800	1,800	1,800
3. Contributions............	1,300	1,300	1,300	1,300
4. Earnings.................	130	200	300	400
5. Total withdrawals........	600	500	600	600
6. Closing balance (Dec. 31 of current year).............	830	1,830	2,830	3,930
7. Amount available for nonmedical withdrawal without penalty	0	0	30	1,030

Direct trustee-to-trustee transfers can be made from one Medicare+Choice MSA to another Medicare+Choice MSA without income inclusion.

The provision includes a correction mechanism so that if contributions for a year are erroneously made by the Secretary of Health and Human Services, such erroneous contributions can be returned to the Secretary of Health and Human Services (along with any attributable earnings) from the Medicare+Choice MSA without tax consequences to the account holder.

Treatment of Medicare+Choice MSA at Death.

Upon the death of the account holder, if the beneficiary of the Medicare+Choice MSA is the account holder's surviving spouse, the surviving spouse may continue the Medicare+Choice MSA, but no new contributions can be made. Distributions from the Medicare+Choice MSA are subject to the rules applicable to MSAs that are not Medicare+Choice MSAs. Thus, earnings on the account balance are not currently includible in income. Distributions from the account for the qualified medical expenses of the spouse or the spouse's dependents (or subsequent spouse) are not includible in income. Distributions used for other than medical expenses are includible in income, and subject to a 15% excise tax unless the distribution is made after the surviving spouse attains age 65, dies, or becomes disabled.

If the beneficiary of a Medicare+Choice MSA is not the account holder's spouse, the Medicare+Choice MSA is no longer treated as a Medicare+Choice MSA and the value of the Medicare+Choice MSA on the account holder's date of death is included in the taxable income of the beneficiary for the taxable year in which the death occurred (under the rules applicable to MSAs generally). If the account holder fails to name a beneficiary, the value of the Medicare+Choice MSA on the account holder's date of death is to be included in the taxable income of the account holder's final income tax return (under the rules applicable to MSAs generally).

In all cases, the value of the Medicare+Choice MSA is included in the account holder's gross estate for estate tax purposes.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to "medical savings account." California's Medi-Cal program supplements the federal Medicare program and is administered by the Department of Health Services.

This bill would conform California law to federal law as it relates to Medicare+Choice MSA.

2. <u>Hospitals Participating in Provider-Sponsored Organizations.</u>

To qualify as a charitable tax-exempt organization described in IRC section 501(c)(3), an organization must be organized and operated <u>exclusively</u> for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international sports competition, or for the prevention of cruelty to children or animals. Although IRC section 501(c)(3) does not specifically mention furnishing medical care and operating a nonprofit hospital, such activities have long been considered to further charitable purposes, provided that the organization benefits the community as a whole.

No part of the net earnings of a 501(c)(3) organization may inure to the benefit of any private shareholder or individual. No substantial part of the activities of a 501(c)(3) organization may consist of carrying on propaganda, or otherwise attempting to influence legislation, and such organization may not participate in, or intervene in, any political campaign on behalf of (or in opposition to) any candidate for public office. In addition, an organization described in IRC sections 501(c)(3) or 501(c)(4) is exempt from tax only if no substantial part of its activities consists of providing commercial-type insurance.

A tax-exempt organization may, subject to certain limitations, enter into a joint venture or partnership with a for-profit organization without affecting its tax-exempt status. Under prior ruling practice, the Internal Revenue Service (IRS) examined the facts and circumstances of each arrangement to determine whether the sharing of profits and losses or other aspects of the arrangement entailed improper private inurement or more than incidental private benefit. See IRS General Counsel Memorandum 39862; Announcement 92-83, 1992-22 I.R.B. 59 (IRS Audit Guidelines for Hospitals). Even where no prohibited private inurement exists, however, more than incidental private benefit conferred on individuals may result in the organization not being operated “exclusively” for an exempt purpose. See, e.g., American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989).

Under **federal law**, prior to the passage of the BBA of 1997, an additional facts and circumstances test was applied to determine whether the venture itself and the participation of the tax-exempt organization therein furthered a charitable purpose.

The **BBA of 1997**, provided that an organization does not fail to be treated as organized and operated exclusively for a charitable purpose for purposes of IRC section 501(c)(3) solely because a hospital which is owned and operated by such organization participates in a provider-sponsored organization (PSO) (as defined in IRC section 1845(a)(1) of the Social Security Act), regardless of whether such PSO is exempt from tax. Thus, participation by a hospital in a PSO (whether taxable or tax-exempt) is deemed to satisfy that the venture and the participation of the tax-exempt organization therein furthers a charitable purpose. The qualification of a hospital as a tax-exempt charitable organization under IRC section 501(c)(3) is determined as under present law.

The BBA of 1997 did not change the restrictions on private inurement and private benefit. However, the provision provides that any person with a material financial interest in such a PSO shall be treated as a private shareholder or individual with respect to the hospital for purposes of applying the private inurement prohibition in Code section 501(c)(3). Accordingly, the facts and circumstances of each PSO arrangement are evaluated to determine whether the arrangement entails impermissible private inurement or more than incidental private benefit (e.g., where there is a disproportionate allocation of profits and losses to the non-exempt partners, the tax-exempt partner makes loans to the joint venture that are commercially unreasonable, the tax-exempt partner provides property or services to the joint venture at less than fair market value, or a non-exempt partner receives more than reasonable compensation for the sale of property or services to the joint venture).

The BBA of 1997 did not change the restrictions on lobbying and political activities. In addition, the restrictions on the provision of commercial-type insurance continue to apply.

California law contains stand alone language that mirrors IRC section 501(c)(3) as it read on January 1, 1997. In addition, California law requires that the assets used by the organization be dedicated to purposes listed in Bank and Corporation Tax Law (B&CTL) IRC section 23701(d) (IRC section 501(c)(3)). California law also contains “inurement” rules similar to the federal rules.

This bill would conform California law to the federal change made by the BBA of 1997. An organization would not fail to be treated as organized and operated exclusively for a charitable purpose for purposes of B&CTL IRC section 23701(d) solely because a hospital which is owned and operated by such organization participates in a PSO regardless of whether such PSO is exempt from tax.

3. Deduction for Student Loan Interest.

Under the **TRA of 1997**, certain individuals may claim an above-the-line deduction for interest paid on qualified education loans, up to a maximum deduction of $2,500 for the 2001 taxable year. The maximum deduction is phased in over four years, with a $1,000 maximum deduction in 1998, $1,500 in 1999, $2,000 in 2000, and $2,500 in 2001, and thereafter. The maximum deduction amount is not indexed for inflation. In addition, the deduction is phased out ratably for individual taxpayers with modified AGI of $40,000-$55,000 ($60,000-$75,000 for joint returns).

The phase-out income ranges will be indexed for inflation occurring after the year 2002, rounded down to the closest multiple of $5,000. Thus, the first taxable year for which the inflation adjustment could be made will be 2003. For purposes of the deduction, modified AGI includes amounts otherwise excluded with respect to income earned abroad (or income from Puerto Rico or U.S. possessions), and is calculated after application of IRC section 86 (income inclusion of certain Social Security benefits), IRC section 219 (deductible IRA contributions), IRC section 469 (limitation on passive activity losses and credits), and amounts excludable from gross income under IRC section 137 (qualified adoption expenses). For purposes of sections 86, 135, 219, 469 and 137, adjusted gross income is determined without regard to the deduction for student loan interest.

Additionally, under **federal law**, any person in a trade or business or any governmental agency that receives $600 or more in qualified education loan interest from an individual during a calendar year must provide an information report on such interest to the IRS and to the payor.

The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Months during which the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year. A qualified education loan generally is defined as any indebtedness incurred to pay for the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending (1) post-secondary educational institutions and certain vocational schools defined by reference to IRC section 481 of the Higher Education Act of 1965, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

Qualified higher education expenses are defined as the student's cost of attendance as defined in IRC section 472 of the Higher Education Act of 1965 (generally, tuition, fees, room and board, and related expenses), reduced by (1) any amount excluded from gross income under IRC section 135, (2) any amount distributed from an education IRA and excluded from gross income, and (3) the amount of any scholarship or fellowship grants excludable from gross income under present-IRC section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under IRC section 127. It is expected that the Secretary of the Treasury will issue regulations setting forth reporting procedures to facilitate the administration of this provision. Specifically, such regulations should require lenders separately to report to borrowers the amount of interest that constitutes deductible student loan interest (i.e., interest on a qualified education loan during the first 60 months in which interest payments are required). In this regard, the regulations should include a method for borrower certification to a lender that the loan proceeds are being used to pay for qualified higher education expenses. Such expenses must be paid or incurred within a reasonable period before or after the indebtedness is incurred, and must be attributable to a period when the student is at least a half-time student.

California law generally is in conformity with the IRC as it read on January 1, 1997, as it relates to educational incentives, which did not specifically allow a deduction for student loan interest. However, under federal and state law a deduction for education expenses generally is allowed if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer’s employer, or requirements of applicable law or regulations, and is imposed as a condition of continued employment. Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses relate to the employee’s current job and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2% of the taxpayer’s adjusted gross income (AGI).

This bill would conform California law to the TRA of 1997 federal change as it relates to the deduction of student loan interest.

4. <u>Modifications of Qualified State Tuition Programs.</u>

Federal and state law provides tax-exempt status to “qualified state tuition programs,” meaning certain programs established and maintained by a state (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver of payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account. “Qualified higher education expenses” are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools).

Federal law was modified by the TRA of 1997 as follows:

- Room and board expenses --The TRA of 1997 expanded the definition of “qualified higher education expenses” to include room and board expenses (meaning the minimum room and board allowance applicable to the student as determined by the institution in calculating costs of attendance for federal financial aid programs under IRC section 472 of the Higher Education Act of 1965) for any period during which the student is at least a half-time student.

- Eligible educational institution --Expanded the definition of "eligible educational institution" by defining the term by reference to IRC section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

- Member of family --Expanded the definition of the term "member of the family" for purposes of allowing tax-free transfers or rollovers of credits or account balances in qualified state tuition programs (and redesignations of named beneficiaries) so that the term means persons described in paragraphs (1) through (8) of IRC section 152(a)--e.g., sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc., and any spouse of such persons.

- Prohibition against investment direction--Clarified the rule that qualified state tuition programs may not allow contributors or designated beneficiaries to direct the investment of contributions to the program (or earnings thereon) by specifically providing that contributors and beneficiaries may not "directly or indirectly" direct the investment of contributions to the program (or earnings thereon).

- Interaction with HOPE credit and lifetime learning credit-- Under the TRA of 1997 (as under prior law), no amount will be includible in the gross income of a contributor to, or beneficiary of, a qualified state tuition program with respect to any contribution to or earnings on such a program until a distribution is made from the program, at which time the earnings portion of the distribution (whether made in cash or in-kind) will be includible in the gross income of the distributee. However, to the extent that a distribution from a qualified state tuition program is used to pay for qualified tuition and fees, the distributee (or another taxpayer claiming the distributee as a dependent) will be able to claim the HOPE credit or lifetime learning credit provided for by the Act with respect to such tuition and fees (assuming that the other requirements for claiming the HOPE credit or lifetime learning credit are satisfied and the modified AGI phaseout for those credits does not apply).

In cases where in-kind benefits are provided to a beneficiary under a qualified state prepaid tuition program, IRC section 529(c)(3)(B) provides that the provision of such benefits is treated as a distribution to the beneficiary. Thus, to the extent such in-kind benefits, if paid for by the beneficiary, would constitute payment of qualified tuition and fees for purposes of the HOPE credit or lifetime learning credit, the beneficiary (or another taxpayer claiming the beneficiary as a dependent) may be able to claim the HOPE credit or lifetime learning credit with respect to payments that are deemed to be made by the beneficiary with respect to the in-kind benefit.

- For federal estate and gift tax purposes, any contribution to a qualified tuition program will be treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Thus contributions made to a qualified tuition program will be eligible for the present-law gift tax exclusion provided by IRC section 2503(b) and also will be excludable for purposes of the generation-skipping transfer tax (provided that the contribution, when combined with any other contributions made by the donor to that same beneficiary, does not exceed the annual gift-tax exclusion limit of $10,000 in the case of an individual or $20,000 in the case of a married couple that splits their gifts). Contributions to a qualified tuition program (either a state-sponsored program or one maintained by a private education institution) will not, however, be eligible for the educational expense exclusion provided by IRC section 2503(e). In no event will a distribution from a qualified tuition program be treated as a taxable gift.

A special rule is provided in the case of contributions that exceed the annual gift tax exclusion limit ($10,000 for individuals). For such contributions, the contributor may elect to have the contribution treated as if made ratably over a five-year period. For example, a $30,000 contribution to a qualified state tuition program would be treated as five annual contributions of $6,000, and the donor could therefore make up to $4,000 in other transfers to the beneficiary each year without payment of gift tax. Under this rule, a donor may contribute up to $50,000 every five years ($100,000 in the case of a married couple) with no gift tax consequences, assuming no other gifts are made from the donor to the beneficiary in the five-year period. A gift tax return must be filed with respect to any contribution in excess of the annual gift-tax exclusion limit, and the election for five-year averaging must be made on the contributor’s gift tax return.

If a donor making an over-$10,000 contribution dies during the five-year averaging period, the portion of the contribution that has not been allocated to the years prior to death is includible in the donor’s estate. For example, if a donor makes a $40,000 contribution, elects to treat the transfer as being made over a five-year period, and dies the following year, $8,000 would be allocated to the year of contribution, another $8,000 would be allocated to the year of death, and the remaining $24,000 would be includible in the gross estate.

If a beneficiary’s interest is rolled over to another beneficiary, there are no transfer tax consequences if the two beneficiaries are in the same generation. If a beneficiary’s interest is rolled over to a beneficiary in a lower generation (e.g., parent to child or uncle to niece), the five-year averaging rule described above may be applied to exempt up to $50,000 of the transfer from gift tax.

Transfers or rollovers of credits or account balances from an account benefiting one beneficiary to an account benefiting another beneficiary (or a change in the designated beneficiary) will not be treated as a taxable gift to the extent that the new beneficiary is: (1) a member of the family of the old beneficiary, and (2) assigned to the same generation as the old beneficiary (within the meaning of IRC section 2651). In all other cases, a transfer from one beneficiary to another beneficiary (or a change in the designated beneficiary) will be treated as a taxable gift from the old beneficiary to the new beneficiary to the extent it exceeds the $10,000 present-law gift tax exclusion. Thus, a transfer of an account from a brother to his sister will not be treated as a taxable gift, whereas a transfer from a father to his son will be treated as a taxable gift (to the extent it exceeds the $10,000 present-law gift tax exclusion).

For estate tax purposes, the value of any interest in a qualified tuition program or education investment account will be includible in the estate of the designated beneficiary. In no event will such interests be includible in the estate of the contributor.

Under **state law**, AB 530 (Stat. 1997, Ch. 851), under the Education Code, created the Golden State Scholarshare Trust, effective for taxable years beginning on or after January 1, 1998. (The Golden State Scholarshare was designed to meet the requirements of IRC section 529 as a state-sponsored qualified tuition program.) The Revenue and Taxation Code was modified to make the Scholarshare trust tax exempt and earnings on the deposits to the trust non-taxable to the participant or beneficiary until the earnings are distributed. AB 530 states under uncodified law, that it is the intent of the Legislature that the Golden State Scholarshare program be maintained as a qualified state tuition program as provided in IRC section 529. Further, AB 530 is to be applied in a manner consistent with IRC section 529 and any ambiguities shall be resolved consistent with IRC section 529.

This bill would conform state law to the federal law as it relates to the qualified state tuition programs.

5. Enhanced Deduction for Corporate Contributions of Computer Technology and Equipment.

Generally, under **federal and state law**, a taxpayer who itemizes deductions is allowed to deduct the fair market value of property contributed to a charitable organization. However, in the case of a charitable contribution of inventory or other ordinary-income property, short-term capital gain property, or certain gifts to private foundations, the amount of the deduction is limited to the taxpayer’s basis in the property. In the case of a charitable contribution of tangible personal property, a taxpayer’s deduction is limited to the adjusted basis in such property if the use by the recipient charitable organization is unrelated to the organization’s tax-exempt purpose.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer. Corporations are entitled to claim a deduction for charitable contributions, generally limited to 10% of their taxable income (computed without regard to the contributions) for the taxable year.

Federal law provides augmented deductions for certain corporate contributions of inventory property for the care of the ill, the needy, or infants, and certain corporate contributions of scientific equipment constructed by the taxpayer, provided the original use of such donated equipment is by the donee for research or research training in the United States in physical or biological sciences. Under these special rules, the amount of the augmented deduction available to a corporation making a qualified contribution is equal to its basis in the donated property plus one-half of the amount of ordinary income that would have been realized if the property had been sold. However, the augmented deduction cannot exceed twice the basis of the donated property. S corporations are not eligible donors for purposes of these special rules. Eligible donees are limited to post-secondary educational institutions, scientific research organizations, and certain other organizations that support scientific research.

The **TRA of 1997** expanded the list of qualified contributions that qualify for the augmented deduction. Under the TRA of 1997, qualified contributions mean gifts of computer technology and equipment (i.e., computer software, computer or peripheral equipment, and fiber optic cable related to computer use) to be used within the United States for educational purposes in any of grades K through 12. This provision is effective for contributions made in taxable years beginning after December 31, 1997, and before January 1, 2001.

Eligible donees are: (1) any educational organization that normally maintains a regular faculty and curriculum and has a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on; and (2) charitable or educational entities that are organized primarily for purposes of supporting elementary and secondary education. A private foundation also is an eligible donee, provided that, within 30 days after receipt of the contribution, the private foundation contributes the property to an eligible donee described above.

Qualified contributions are limited to gifts made no later than two years after the date the taxpayer acquired or substantially completed the construction of the donated property. In addition, the TRA of 1997 clarifies that the original use of the donated property must commence with the donor or the donee. Accordingly, qualified contributions generally are limited to property that is no more than two years old. Such donated property could be computer technology or equipment that is inventory or depreciable trade or business property in the hands of the donor. The TRA of 1997 permits payment by the donee organization of shipping, transfer, and installation costs. The special treatment applies only to donations made by C corporations. S corporations, personal holding companies, and service organizations are not eligible donors.

In the case of contributions made through private foundations, the TRA of 1997 permits the payment by the private foundation of shipping, transfer, and installation costs.

Under **California law**, charitable contributions can be deducted by corporations up to 10% of its modified net income (computed without regard to contributions, built-in gains and organizational expense deductions). California law limits the charitable contribution of property to the corporation's basis in the property. Prior California law did allow an augmented deduction for contribution of "qualified research property," similar to the federal augmented contribution of scientific property. To qualify for the California augmented contribution, the deduction had to be made between July 1, 1983, and December 31, 1993.

This bill would conform California law to the TRA of 1997 federal change in the augmented deduction for computer technology and equipment to be used within California for educational purposes in any of grades K through 12. This bill would not conform to the augmented deduction of corporate contributions of inventory property for the care of the ill, the needy, or infants, and certain corporate contributions of scientific equipment.

6. <u>Treatment of Cancellation of Certain Student Loans.</u>

Under **federal and state law**, in the case of an individual, gross income subject to income tax does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses. In addition, the loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a state (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a state, county, or municipal hospital and whose employees have been deemed to be public employees under state law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a state, or a tax-exempt public benefit corporation. Thus, loans made with private, nongovernmental funds are not qualifying student loans for purposes of the exclusion.

The **TRA of 1997** expanded the exclusion so that an individual's gross income does not include forgiveness of loans made by educational organization (and certain tax-exempt charitable organizations in the case of refinancing loans) if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance outstanding student loans and the student is not employed by the lender organization. As under present law, the exclusion applies only if the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers. In addition, in the case of loans made by tax-exempt charitable organizations, the student's work must fulfill a public service requirement. The student must work in an occupation or area with unmet needs and such work must be performed for or under the direction of a tax-exempt charitable organization or a governmental entity. This provision applies to discharges of indebtedness occurring after August 5, 1997.

California law conformed to the federal law as it read on January 1, 1997, prior to the TRA of 1997 change as it relates to the cancellation of student loan income. In addition, AB 364 (Stat. 1997, Ch. 228) provides that any loan made pursuant to the Forgivable Loan Program of the California State University would be a "student loan" for purposes of the exclusion from gross income of income resulting from discharges of student loan indebtedness.

This bill would conform California law to the TRA of 1997 federal change to the forgiveness of student loans. This bill would not change the Forgivable Loan Program of the California State University system.

7. <u>Repeal the Depreciation Adjustment for Alternative Minimum Tax.</u>

Under **federal law**, in computing alternative minimum taxable income (AMTI), depreciation on property placed in service after 1986 must be computed by using class lives prescribed by the alternative depreciation system and either (1) the straight-line method in the case of property subject to the straight-line method under the regular tax or (2) the 150% declining balance method in the case of other property. For regular tax purposes, depreciation on tangible personal property generally is computed using shorter recovery periods and more accelerated methods than are allowed for alternative minimum tax (AMT) purposes.

Under **federal law**, for property (including pollution control facilities) placed in service after December 31, 1998, the TRA of 1997 permits the recovery periods (but not the methods) used for purposes of alternative minimum tax (AMT) depreciation adjustment to be the same as the recovery periods used for purposes of regular tax. The recovery periods now allowed for AMT purposes are those allowed under the modified accelerated cost recovery system (MACRS).

For individuals and corporations, **California law** is conformed to the federal rules prior to the passage of the TRA with respect to the amount allowable in computing AMTI. An adjustment is required to be made for the difference between the amount allowed as depreciation for regular tax purposes and the amount allowed as depreciation for AMT purposes. Although the federal rules apply for determining the amount allowable for AMT purposes, the amount of the actual adjustment may be different, due to differences (past and present) in state and federal rules for computing depreciation for regular tax purposes.

California law allows a taxpayer to use MACRS under the PITL. MACRS is not an acceptable method of depreciation under the B&CTL.

For California and federal law, the AMTI of a corporation is increased by an amount equal to 75% of the amount by which adjusted current earnings (ACE) of the corporation exceed AMTI (as determined before this adjustment). In general, ACE is AMTI with additional adjustments that generally follow the rules presently applicable to corporations in computing their earnings and profits. For purposes of California law and federal law prior to 1994, ACE depreciation is computed using the straight-line method over the class life of the property. Thus, a corporation generally must make two depreciation calculations for purposes of the AMT -- once using the 150% declining balance method over the class life and again using the straight-line method over the class life. Taxpayers may elect to use either method for regular tax purposes. If a taxpayer uses the straight-line method for regular tax purposes, it must also use the straight-line method for AMT purposes. The ACE depreciation adjustment was eliminated from federal law for property placed in service after December 31, 1993. California has not conformed to the elimination of the ACE depreciation adjustment.

This bill would conform California law to the TRA of 1997 federal change allowing the same depreciable lives used for regular tax purposes to be used for AMT purposes.

8. Repeal of Throwback Rules Applicable to Domestic Trusts.

A nongrantor trust is treated as a separate taxpayer for **federal income tax** purposes. Such a trust generally is treated as a conduit with respect to amounts distributed currently and taxed with respect to any income which is accumulated in the trust rather than distributed. The conduit treatment is achieved by allowing the trust a deduction for amounts distributed to beneficiaries during the taxable year to the extent of distributable net income and by including such distributions in the beneficiaries’ income.

Under **federal law, a** separate graduated tax rate structure applies to trusts, which historically has permitted accumulated trust income to be taxed at lower rates than the rates applicable to trust beneficiaries. This benefit often was compounded through the creation of multiple trusts.

The IRC has several rules intended to limit the benefit that would otherwise occur from using the lower rates applicable to one or more trusts. Under the so-called “throwback” rules, the distribution of previously accumulated trust income to a beneficiary will be subject to tax (in addition to any tax paid by the trust on that income) where the beneficiary's average top marginal rate in the previous five years is higher than those of the trust.

Under IRC section 643(f), two or more trusts are treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is to avoid federal income tax. For trusts that were irrevocable as of March 1, 1984, IRC section 643(f) applies only to contributions to corpus after that date. Under IRC section 644, if property is sold within two years of its contribution to a trust, the gain that would have been recognized had the contributor sold the property is taxed at the contributor's marginal tax rates. In effect, IRC section 644 treats such gains as if the contributor had realized the gain and then transferred the net after-tax proceeds from the sale to the trust as corpus.

IRC sections 665 through 668 apply different rules to distributions of previously accumulated trust income from a foreign trust than to distributions of such income from domestic trusts. If a foreign trust accumulates income, changes its situs so as to become a domestic trust, and then makes a distribution that is deemed to have been made in a year in which the trust was a foreign trust, the distribution is treated as a distribution from a foreign trust for purposes of the accumulation distribution rules.

The **TRA of 1997** generally exempts from the throwback rules amounts distributed by a domestic trust after August 5, 1997. The throwback rule continues to apply with respect to (1) foreign trusts, (2) domestic trusts that were once treated as a foreign trust (except as provided in Treasury regulations), and (3) domestic trusts created before March 1, 1984, that are treated as multiple trusts under IRC section 643(f).

The **TRA of 1997** also provides that precontribution gain on property sold by a domestic trust is no longer subject to IRC section 644 (i.e., taxed at the contributor’s marginal tax rate.)

California law is in conformity with federal law as in effect and as it relates to distributions of accumulated trust income prior to August 5, 1997. California has additional rules relating to trusts located outside of the state with resident beneficiaries.

This bill would conform California law to the TRA of 1997 federal change as it relates to distributions from trusts.

9. Home Office Deduction: Clarification of Definition of Principal Place of Business.

The **TRA of 1997** amended section 280A to specifically provide that a home office qualifies as the “principal place of business” if (1) the office is used by the taxpayer to conduct administrative or management activities of a trade or business and (2) there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

As under prior law, deductions will be allowed for a home office meeting the above two-part test only if the office is exclusively used on a regular basis as a place of business by the taxpayer and, in the case of an employee, only if such exclusive use is for the convenience of the employer. Thus, under the TRA of 1997, a home office deduction is allowed (subject to the “convenience of the employer” rule governing employees) if a portion of a taxpayer's home is exclusively and regularly used to conduct administrative or management activities for a trade or business of the taxpayer, who does not conduct substantial administrative or management activities at any other fixed location of the trade or business, regardless of whether administrative or management activities connected with his trade or business (e.g., billing activities) are performed by others at other locations. The fact that a taxpayer also carries out administrative or management activities at sites that are not fixed locations of the business, such as a car or hotel room, will not affect the taxpayer's ability to claim a home office deduction. Moreover, if a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer still is eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home are not substantial (e.g., the taxpayer occasionally does minimal paperwork at another fixed location of the business). In addition, a taxpayer's eligibility to claim a home office deduction under the TRA of 1997 will not be affected by the fact that the taxpayer conducts substantial non-administrative or non-management business activities at a fixed location of the business outside the home (e.g., meeting with, or providing services to, customers, clients, or patients at a fixed location of the business away from home).

If a taxpayer in fact does not perform substantial administrative or management activities at any fixed location of the business away from home, then the second part of the test will be satisfied, regardless of whether the taxpayer opted not to use an office away from home that was available for the conduct of such activities. However, in the case of an employee, the question whether an employee chose not to use suitable space made available by the employer for administrative activities is relevant to determining whether the present-law “convenience of the employer” test is satisfied. In cases where a taxpayer's use of a home office does not satisfy the provision's two-part test, the taxpayer nonetheless may be able to claim a home office deduction under the present-law "principal place of business" exception or any other provision of IRC section 280A. This provision is effective for taxable years beginning after December 31, 1998.

The **California PITL** is fully conformed to the federal law as it relates to a home office deduction as it read on January 1, 1997. A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home. However, these business deductions generally are allowed only with respect to the portion of a home that is used exclusively and regularly in one of the following ways: (1) as the principal place of business for a trade or business; (2) as a place of business used to meet with patients, clients, or customers in the normal course of the taxpayer's trade or business; or (3) in connection with the taxpayer's trade or business, if the portion so used constitutes a separate structure not attached to the dwelling unit.

Under **federal and state law**, prior to 1976, expenses attributable to the business use of a residence were deductible whenever they were "appropriate and helpful" to the taxpayer's business. In 1976, Congress adopted IRC section 280A, in order to provide a narrower scope for the home office deduction, but did not define the term "principal place of business." In Commissioner v. Soliman, 113 S.Ct. 701 (1993), the Supreme Court reversed lower court rulings and upheld an IRS interpretation of IRC section 280A that disallowed a home office deduction for a self-employed anesthesiologist who practiced at several hospitals but was not provided office space at the hospitals. Although the anesthesiologist used a room in his home exclusively to perform administrative and management activities for his profession (i.e., he spent two or three hours a day in his home office on bookkeeping, correspondence, reading medical journals, and communicating with surgeons, patients, and insurance companies), the Supreme Court upheld the IRS position that the principal place of business for the taxpayer was not the home office, because the taxpayer performed the "essence of the professional service" at the hospitals. Because the taxpayer did not meet with patients at his home office and the room was not a separate structure, a deduction was not available under the second or third exception under IRC section 280A(c)(1). Effective for taxable years beginning after December 31, 1998, the TRA of 1997 supersedes the Soliman decision for federal purposes.

This bill would conform California law to the TRA of 1997 federal changes made to the home office deduction. This provision would be operative for taxable years beginning after December 31, 1998.

10. Expensing of Environmental Remediation Costs ("Brownfields").

Federal and state law allow a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Treasury regulations provide that the cost of incidental repairs which neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted currently as a business expense. The law prohibits a current deduction for certain capital expenditures. Treasury regulations define "capital expenditures" as amounts paid or incurred that materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use.

Amounts paid for repairs and maintenance do not constitute capital expenditures. The determination of whether an expense is deductible or capitalizable is based on the facts and circumstances of each case.

Federal and state law provide that capital expenditures include the costs of acquiring or substantially improving buildings, machinery, equipment, furniture, fixtures and similar property having a useful life substantially beyond the current year. In INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992), the Supreme Court required the capitalization of legal fees incurred by a taxpayer in connection with a friendly takeover by one of its customers on the grounds that the merger would produce significant economic benefits to the taxpayer extending beyond the current year; capitalization of the costs thus would match the expenditures with the income produced. Although Treasury regulations provide that expenditures that materially increase the value of property must be capitalized, they do not set forth a method of determining how and when value has been increased. In Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacq., the U.S. Tax Court held that increased value was determined by comparing the value of an asset after the expenditure with its value before the condition necessitating the expenditure. The Tax Court stated that "an expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."

In several Technical Advice Memoranda (TAM), the Internal Revenue Service (IRS) declined to apply the Plainfield-Union valuation analysis, indicating that the analysis represents just one of several alternative methods of determining increases in the value of an asset. In TAM 9240004 (June 29, 1992), the IRS required certain asbestos removal costs to be capitalized rather than expensed. In that instance, the taxpayer owned equipment that was manufactured with insulation containing asbestos; the taxpayer replaced the asbestos insulation with less thermally efficient, non-asbestos insulation. The IRS concluded that the expenditures resulted in a material increase in the value of the equipment because the asbestos removal eliminated human health risks, reduced the risk of liability to employees resulting from the contamination, and made the property more marketable. Similarly, in TAM 9411002 (November 19, 1993), the IRS required the capitalization of expenditures to remove and replace asbestos in connection with the conversion of a boiler room to garage and office space. However, the IRS permitted deduction of costs of encapsulating exposed asbestos in an adjacent warehouse.

In 1994, the IRS issued a Revenue Ruling (Rev. Rul. 94-38) holding that soil remediation expenditures and ongoing water treatment expenditures incurred to clean up land and water that a taxpayer contaminated with hazardous waste are deductible. In this ruling, the IRS explicitly accepted the Plainfield-Union valuation analysis. However, the IRS also held that costs allocable to constructing a groundwater treatment facility are capital expenditures. Rev. Rul. 94-38 generally rendered moot the holding in TAM 9315004 (December 17, 1992) requiring a taxpayer to capitalize certain costs associated with the remediation of soil contaminated with polychlorinated biphenyls (PCBs).

In 1995, the IRS issued TAM 9541005 (October 13, 1995) requiring a taxpayer to capitalize certain environmental study costs, as well as associated consulting and legal fees. The taxpayer acquired the land and conducted activities causing hazardous waste contamination. After the contamination, but before it was discovered, the company donated the land to the county to be developed into a recreational park. After the county discovered the contamination, it reconveyed the land to the company for $1. The company incurred the costs in developing a remediation strategy. The IRS held that the costs were not deductible under IRC section 162 because the company acquired the land in a contaminated state when it purchased the land from the county. In January, 1996, the IRS revoked and superseded TAM 9541005 (PLR 9627002). Noting that the company's contamination of the land and liability for remediation were unchanged during the break in ownership by the county, the IRS concluded that the break in ownership should not, in and of itself, operate to disallow a deduction under IRC section 162.

The **TRA of 1997** provides that taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to a capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for such property that would otherwise be allocated to the site under the principles set forth in Comm'r v. Idaho Power Co., 418 U.S. 1 (1974), and the IRC are treated as qualified environmental remediation expenditures. (Comm'r v. Idaho Power Co. held that equipment depreciation allocable to the taxpayer's construction of capital facilities must be capitalized under IRC section 263(a)(1)).

A "qualified contaminated site" generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate state environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called "brownfields"). Targeted areas would mean (1) empowerment zones and enterprise communities as designated under present law and under the TRA of 1997 (including any supplemental empowerment zone designated on December 21, 1994); (2) sites announced before February 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) Brownfields Pilots; (3) any population census tract with a poverty rate of 20% or more; and (4) certain industrial and commercial areas that are adjacent to tracts described in (3) above. Both urban and rural sites qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) cannot be targeted areas.

With respect to certification of targeted areas, the TRA of 1997 provides that the chief executive officer of a state may, in consultation with the Administrator of the EPA, designate an appropriate state environmental agency. If no state environmental agency is so designated within 60 days of the date of enactment, the appropriate environmental agency for such state shall be designated by the Administrator of the EPA.

Hazardous substances generally are defined by reference to sections 101(14) and 102 of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

The **TRA of 1997** further provides that, in the case of property to which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under the TRA of 1997 is treated as a depreciation deduction and the property is treated as subject to IRC section 1245 property. Thus, deductions for qualified environmental remediation expenditures would be subject to recapture as ordinary income upon sale or other disposition of the property.

California law generally conforms to the federal trade or business expense deduction provisions as they existed on January 1, 1997. In addition, California provides certain special business expense deductions. For instance, a business located in an economic development area may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the economic development area.

California law is conformed to the federal treatment (current expenditure or capital item) of environmental remediation expenditures prior to the enactment of the TRA of 1997. California law is not conformed to the new federal “brownfields” business expense deduction.

This bill would conform California law to the TRA of 1997 federal change as it relates to the election to expense environmental remediation costs. This bill would not permit a separate election for state purposes.

11. Shrinkage Estimates for Inventory Accounting.

Where a taxpayer maintains book inventories in accordance with a sound accounting system, the net value of the inventory will be deemed to be the cost basis of the inventory, provided that such book inventories are verified by physical inventories at reasonable intervals and adjusted to conform therewith. The physical count is used to determine and adjust for certain items, such as undetected theft, breakage, and bookkeeping errors, collectively referred to as “shrinkage.”

Some taxpayers verify and adjust their book inventories by a physical count taken on the last day of the taxable year. Other taxpayers may verify and adjust their inventories by physical counts taken at other times during the year. Still other taxpayers take physical counts at different locations at different times during the taxable year (cycle counting).

If a physical inventory is taken at year-end, the amount of shrinkage for the year is known. If a physical inventory is not taken at year-end, shrinkage through year-end will have to be based on an estimate, or not taken into account until the following year. In the first decision in Dayton Hudson v. Commissioner, 101 T.C. 462 (1993), the U.S. Tax Court held that a taxpayer's method of accounting may include the use of an estimate of shrinkage occurring through year-end, provided the method is sound and clearly reflects income. In the second decision in Dayton Hudson v. Commissioner (T.C. Memo 1997-260), the U.S. Tax Court adhered to this holding. However, the U.S. Tax Court in the second decision determined that this taxpayer had not established that its method of accounting clearly reflected income. Other cases decided by the U.S. Tax

Court have held that taxpayers' methods of accounting that included shrinkage estimates do clearly reflect income.

The U.S. Tax Court in the second Dayton Hudson opinion noted, "In most cases, generally accepted accounting principles (GAAP), consistently applied, will pass muster for tax purposes. The Supreme Court has made clear, however, that GAAP does not enjoy a presumption of accuracy that must be rebutted by the Commissioner."

The **TRA of 1997** provided that a method of keeping inventories will not be considered unsound, or to fail to clearly reflect income, solely because it includes an adjustment for the shrinkage estimated to occur through year-end, based on inventories taken other than at year-end. Such an estimate must be based on actual physical counts. Where such an estimate is used in determining ending inventory balances, the taxpayer is required to take a physical count of inventories at each location on a regular and consistent basis. A taxpayer is required to adjust its ending inventory to take into account all physical counts performed through the end of its taxable year.

It is anticipated that the Secretary of the Treasury will issue guidance establishing one or more safe harbor methods for the estimation of inventory shrinkage that will be deemed to result in a clear reflection of income, provided such safe harbor method is consistently applied and the taxpayer's inventory methods otherwise satisfy the clear reflection of income standard. The safe harbor method should use a historical ratio of shrinkage to sales, multiplied by total sales between the date of the last physical inventory and year-end. This historical ratio is based on the actual shrinkage established by all physical inventories taken during the most recent three taxable years and the sales for related periods. The historical ratio should be separately determined for each store or department in a store of the taxpayer. The historical ratio, or estimated shrinkage determined using the historical ratio, cannot be adjusted by judgmental or other factors (e.g., floors or caps). Estimated shrinkage determined in accordance with the consistent application of the safe harbor method will not be required to be recalculated, through a lookback adjustment or otherwise, to reflect the results of physical inventories taken after year-end. In the case of a new store or department in a store that has not verified shrinkage by a physical inventory in each of the most recent three taxable years, the historical ratio is the average of the historical ratios of the retailer's other stores or departments. Retailers using last in, first out (LIFO) methods of inventory are expected to be required to allocate shrinkage among their various inventory pools in a reasonable and consistent manner.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the valuation of inventory.

This bill would conform California law to the TRA of 1997 federal change as it relates to the valuation of inventory.

12. Timeshare Associations.

Under **federal law**, condominium management associations and residential real estate management associations may elect under IRC section 528 to be taxable at a 30% rate on their "homeowners association income" if they meet certain income, expenditure, and organizational requirements. “Homeowners association income” is the excess of the association's gross income, excluding “exempt function income,” over allowable deductions directly connected with nonexempt function gross income. Exempt function income includes membership dues, fees, and assessments for a common activity undertaken by association members or owners of residential units in the condominium or subdivision. Homeowners association income includes passive income (e.g., interest and dividends) earned on reserves and fees for use of association property (e.g., swimming pools, meeting rooms, etc.).

For an association to qualify for this treatment: (1) at least 60% of the association's gross income must consist of membership dues, fees, or assessments on owners; (2) at least 90% of its expenditures must be for the acquisition, management, maintenance, or care of “association property”; and (3) no part of its net earnings can inure to the benefit of any private shareholder. Association property means: (1) property held by the association; (2) property commonly held by association members; (3) property within the association privately held by association members; and (4) property held by a governmental unit for the benefit of association members. In addition to these statutory requirements, Treasury regulations require that the units of the association be used for residential purposes. Use is not a residential use if the unit is occupied by a person or series of persons for less than 30 days for more than half of the association's taxable year.

Taxation of Homeowners Associations Not Making the IRC section 528 Election.

Homeowners associations that do not (or cannot) make the IRC section 528 election are taxed either as a tax-exempt social welfare organization under IRC section 501(c)(4) or as a regular C corporation. In order for an organization to qualify as a tax-exempt social welfare organization, the organization must meet the following three requirements: (1) the association must serve a community which bears a reasonable, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit; (2) the association may not conduct activities directed to exterior maintenance of any private residence, and (3) common areas of association facilities must be for the use and enjoyment of the general public. Non-exempt homeowners associations are taxed as C corporations, except that: (1) the association may exclude excess assessments that it refunds to its members or applies to the subsequent year's assessments; (2) gross income does not include special assessments held in a special bank account; and (3) assessments for capital improvements are treated as non-taxable contributions to capital.

Taxation of Timeshare Associations.

Timeshare associations, prior to the passage of the TRA of 1997, were taxed as regular C corporations because (1) they cannot meet the requirement of the Treasury regulations for the IRC section 528 election that the units be used for residential purposes (i.e., the 30-day rule) and they have relatively large amount of services performed for its owners (e.g., maid and janitorial services) and (2) they cannot meet any of requirements of Rev. Rul. 74-99 for tax-exempt status under IRC section 501(c)(4).

The **TRA of 1997** amended IRC section 528 to permit timeshare associations to qualify for taxation under that IRC section. Timeshare associations will have to meet the requirements of IRC section 528 (e.g., the 60% gross income, 90%

expenditure, and the non-profit organizational and operational requirements). Timeshare associations electing to be taxed under IRC section 528 are subject to a tax on their timeshare association income at a rate of 32%.

60-Percent Test.

A qualified timeshare association must receive at least 60% of its income from membership dues, fees and assessments from owners of either (a) timeshare rights to use of, or (b) timeshare ownership in, the timeshare association property.

90-Percent Test.

At least 90% of the expenditures of the timeshare association must be for the acquisition, management, maintenance, or care of association property, and activities provided by the association to, or on behalf of, members of the timeshare association. Activities provided to or on behalf of members of the timeshare association includes events located on association property (e.g., member's meetings at the association's meeting room, parties at the association's swimming pool, golf lessons on association's golf range, transportation to and from association property, etc.).

Organizational and Operational Tests.

The TRA of 1997 provided that association property includes property in which a timeshare association or members of the association have rights arising out of recorded easements, covenants, and other recorded instruments to use property related to the timeshare project. No part of the net earnings of the timeshare association can inure to the benefit (other than by acquiring, constructing, or providing management, maintenance, and care of property of the timeshare association or rebate of excess membership dues, fees, or assessments) of any private shareholder or individual. A member of a qualified timeshare association must hold a timeshare right to use (or timeshare ownership in) real property of the association. A qualified timeshare association cannot be a condominium management association. The timeshare association must elect to be taxed under IRC section 528.

California law is in conformity with federal law as it relates to the taxation of homeowner associations. A homeowners association is subject to tax on its "homeowner association taxable income" at the corporate income tax rates. California treats timeshare associations as C corporations.

This bill would conform California law to the TRA of 1997 federal change as it relates to taxation of timeshare associations. Timeshare associations would be subject to tax on its "timeshare association taxable income" at the corporate income tax rates

13. <u>Increased Deduction for Business Meals for Individuals under Department of Transportation Limitations.</u>

Under **federal law** prior to the TRA of 1997 and current **California law**, ordinary and necessary business expenses, as well as expenses incurred for the production of income, are generally deductible, subject to a number of restrictions and limitations. Generally, the amount allowable as a deduction for food and beverages is limited to 50% of the otherwise deductible amount. Exceptions to this 50% rule are provided for food and beverages provided to the crew of certain vessels and offshore oil or gas platforms or drilling rigs.

The **TRA of 1997** increased to 80% the deductible percentage of the cost of food and beverages consumed while away from home by an individual during, or incident to, a period of duty subject to the hours of service limitations of the Department of Transportation. Individuals subject to the hours of service limitations of the Department of Transportation include:

(1) certain air transportation employees such as pilots, crew, dispatchers, mechanics, and control tower operators pursuant to Federal Aviation Administration regulations,
(2) interstate truck operators and interstate bus drivers pursuant to Department of Transportation regulations,
(3) certain railroad employees such as engineers, conductors, train crews, dispatchers and control operations personnel pursuant to Federal Railroad Administration regulations, and
(4) certain merchant mariners pursuant to Coast Guard regulations.

The increase in the deductible percentage is phased in according to the following schedule:

Taxable Years Beginning In	Deductible Percentage
1998, 1999	55
2000, 2001	60
2002, 2003	65
2004, 2005	70
2006, 2007	75
2008 and thereafter	80

This bill would conform California law to the TRA of 1997 federal change as it relates to an increased percentage deduction for business meals for individuals subject to Department of Transportation limitations.

14. <u>Deductibility of Meals Provided for the Convenience of the Employer.</u>

Prior to the passage of TRA of 1997, in general, subject to several exceptions, only 50% of business meal and entertainment expenses were allowed as a deduction. Under one exception, the value of meals that are excludable from employees' incomes as a de minimis fringe benefit are fully deductible by the employer. In addition, the courts that have considered the issue have held that if meals are provided for the convenience of the employer under existing federal law they are fully deductible pursuant to other provisions of federal law provided they satisfy the relevant requirements regarding federal tax treatment of fringe benefits.

The **TRA of 1997** provides that meals that are excludable from employees' incomes because they are provided for the convenience of the employer pursuant to IRC section 119 are excludable as a de minimis fringe benefit and therefore are <u>fully</u> deductible by the employer, provided they satisfy the relevant IRC section 132 requirements. No inference is intended as to whether such meals were fully deductible under prior law.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to the deductibility of meals.

This bill would conform California law to the TRA of 1997 federal change as it relates to the deductibility of meals.

15. Modify Limits on Depreciation of Luxury Automobiles for Clean-Burning Fuel and Electric Vehicles.

Prior to the passage of the TRA of 1997, the amount a taxpayer could claim as a depreciation deduction for any passenger automobile was limited to: $2,560 for the first taxable year in the recovery period; $4,100 for the second taxable year in the recovery period; $2,450 for the third taxable year in the recovery period; and $1,475 for each succeeding taxable year in the recovery period. Each of the dollar limitations was indexed for inflation after October 1987 by the automobile component of the Consumer Price Index. Consequently, the limitations applicable for 1997 were $3,160, $5,000, $3,050, and $1,775.

The **TRA of 1997** modified the limitation on depreciation in the case of qualified clean-burning fuel vehicles and certain electric vehicles. With respect to vehicles that are modified to permit such vehicle to be propelled by a clean burning fuel, the TRA of 1997 applies the limitation to that portion of the vehicles' cost not represented by the installed qualified clean-burning fuel property. The taxpayer may claim an amount otherwise allowable as a depreciation deduction on the installed qualified clean-burning fuel, without regard to the limitation. Generally, this has the same effect as subjecting only the cost of the vehicle before modification to the limitations.

In the case of a passenger vehicle designed to be propelled primarily by electricity and built by an original equipment manufacturer, the base-year limitation amounts of $2,560 for the first taxable year in the recovery period, $4,100 for the second taxable year in the recovery period, $2,450 for the third taxable year in the recovery period, and $1,475 for each succeeding taxable year in the recovery period are tripled to $7,680, $12,300, $7,350, and $4,425, respectively, and then adjusted for inflation after October 1987 by the automobile component of the Consumer Price Index.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to depreciation of "luxury" automobiles.

This bill would conform California law to the TRA of 1997 federal change as it relates to the depreciation of clean-burning fuel and electric vehicles.

16. Suspension of Income Limitations on Percentage Depletion for Production from Marginal Wells.

Federal and California law permit taxpayers to recover their investments in oil and gas wells through depletion deductions. In the case of certain properties, the deductions may be determined using the percentage depletion method. Certain limitations apply in calculating percentage depletion deductions. One limitation for oil and gas property is a restriction that these deductions may not exceed 65% of the taxpayer's taxable income.

Under **federal law prior** to the passage of the TRA of 1997, and current California law, another limitation is a restriction that the amount deducted may not exceed 100% of the net income from that property in any year. Specific percentage depletion rules apply to oil and gas production from "marginal properties." Marginal production is defined as domestic crude oil and natural gas production from stripper well property or from property from which substantially all of the production during the calendar year is heavy oil. Stripper well property is property from which the average daily production is 15 barrel equivalents or less, determined by dividing the average daily production of domestic crude oil and domestic natural gas from producing wells on the property for the calendar year by the number of wells. Heavy oil is domestic crude oil with a weighted average gravity of 20 degrees API or less (corrected to 60 degrees Fahrenheit).

The **TRA of 1997** suspended the 100% of net income property limitation for domestic oil and gas production from marginal properties during taxable years beginning after December 31, 1997, and before January 1, 2000.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to percentage depletion of oil and gas wells.

This bill would conform California law to the TRA of 1997 federal change as it relates to temporary suspension of income limitations on percentage depletion for production from marginal wells.

17. <u>Increase in Standard Mileage Rate for Purposes of Computing Charitable Deduction.</u>

In general, individuals who itemize their deductions may deduct charitable contributions. For this purpose, charitable contributions include the amount of any mileage expenses incurred in connection with the charitable activities

The **TRA of 1997** increased the mileage rate from 12 cents to 14 cents per mile.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the mileage rate of 12 cents used for charitable activities.

This bill would conform California law to the TRA of 1997 federal change as it relates to the increase in the standard mileage rate for purposes of computing a charitable deduction.

18. <u>Purchasing of Receivables by Tax-Exempt Hospital Cooperative Organizations.</u>

IRC section 501(e) provides that an organization organized on a cooperative basis by tax-exempt hospitals will itself be tax-exempt if the organization is operated solely to perform, on a centralized basis, one or more of certain enumerated services for its members. These services are: data processing, purchasing (including the purchase of insurance on a group basis), warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel services. An organization does not qualify under IRC section 501(e) if it performs services other than the enumerated services.

The **TRA of 1997** clarified that, for purposes of IRC section 501(e), billing and collection services include the purchase of patron accounts receivable on a recourse basis. Thus, hospital cooperative service organizations are permitted to advance cash on the basis of member accounts receivable, provided that each member hospital retains the risk of non-payment with respect to its accounts receivable. No inference is intended with respect to taxable years prior to the effective date of this change.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to hospital cooperatives.

This bill would conform California law to the TRA of 1997 federal change as it relates to the purchase by hospital cooperatives of certain accounts receivable.

19. <u>Provide Above-the-Line Deduction for Certain Business Expenses.</u>

Under **federal and state law**, individuals may generally deduct ordinary and necessary business expenses in determining AGI . This deduction does not apply in the case of an individual performing services as an employee. Employee business expenses are generally deductible only as a miscellaneous itemized deduction, i.e., only to the extent all of the taxpayer's miscellaneous itemized deductions exceed 2% of the taxpayer's AGI. Employee business expenses are not allowed as a deduction for alternative minimum tax purposes.

Under the **TRA of 1997**, employee business expenses relating to service as an official of a state or local government (or political subdivision thereof) are deductible in computing AGI (above the line), provided the official is compensated in whole or in part on a fee basis. Consequently, such expenses are also deductible for alternative minimum tax purposes.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the deductibility of employee business expenses. Government officials are generally only permitted to deduct employee business expenses as a miscellaneous itemized deduction.

This bill would conform California law to the TRA of 1997 federal change as it relates to employee business expenses of an official of a state or local government.

20. <u>Required Recognition of Gain on Certain Appreciated Financial Positions in Personal Property.</u>

Under **federal and California law**, in general, gain or loss is taken into account for tax purposes when realized. Gain or loss generally is realized with respect to a capital asset at the time the asset is sold, exchanged, or otherwise disposed of. Special rules defer or accelerate recognition in certain circumstances. Transactions designed to reduce or eliminate risk of loss, such as a “short sale against the box,” or an “equity swap,” generally do not cause realization.

The **TRA of 1997** requires recognition of gain (but not loss) upon entering into a constructive sale of any “appreciated financial position” in stock, a partnership interest or debt other than certain “straight” debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of constructive sale. A constructive sale occurs when the taxpayer enters into one of the following transactions with respect to the same or substantially identical property: (1) a short sale, (2) an offsetting notional principal contract, or (3) a futures or forward contract. For a taxpayer who has one of these transactions, a constructive sale occurs when it acquires the related long position. Other transactions will be treated as constructive sales to the extent provided in Treasury regulations.

The TRA of 1997 provided an exception for certain short term hedges that would otherwise be treated as a constructive sale if all three conditions are met:

- the transaction is closed before the end of the 30th day after the close of the taxable year.
- the taxpayer holds the appreciated financial position.
- at no time during a 60-day period is the taxpayer's risk of loss reduced by holding certain other positions.

The TRA of 1997 also provided that the types of debt instruments excluded from the definition of “appreciated financial position” are instruments that are not convertible and the interest on which is either fixed, payable at certain variable rates, or based on certain interest payments on a pool of mortgages. In addition, the TRA of 1997 provided an exception for transactions closed during the 90-day period ending on the 30th day after the close of the taxable year and reestablished during such period, so long as the normal requirements for positions closed within such 90-day period are met by the reestablished position.

A trust instrument that is actively traded is generally treated as stock for purposes of determining whether the instrument is an appreciated financial position. The TRA of 1997 provided that a trust instrument will not be treated as stock if substantially all (by value) of the property held by the trust is debt that qualifies for the exception to the definition of appreciated financial position for certain debt instruments. In addition, only debt instruments that entitle the holder to receive an unconditional principal amount qualify for the exception.

The Joint Committee on Taxation’s report clarifies some aspects of the application of the provision. Congress did not intend that an agreement that is not a contract for purposes of applicable contract law will be treated as a forward contract. Thus, contingencies to which the contract is subject will generally be taken into account. Congress intended that the constructive sale provision generally will apply to transactions that are identified hedging or straddle transactions under other code provisions. Where either position in such an identified transaction is an appreciated financial position and a constructive sale of such position results from the other position, the conferees intended that the constructive sale will be treated as having occurred immediately before the identified transaction. The constructive sale will not, however, prevent qualification of the transaction as an identified hedging or straddle transaction. Where, after the establishment of such an identified transaction, there is a constructive sale of either position in the transaction, gain will generally be recognized and accounted for under the relevant hedging or straddle provision. However, Congress intended that future Treasury regulations may except certain transactions from the constructive sale provision where the gain recognized would be deferred under an identified hedging or straddle provision.

The Joint Committee on Taxation's report urges that the Treasury issue prompt guidance, including safe harbors, with respect to common transactions entered into by taxpayers. The legislative history to both the House bill and the Senate amendment describe "collar" transactions and recommend that Treasury regulations provide standards for determining which collar transactions result in constructive sales. The Joint Committee on Taxation Report expects that these Treasury regulations with respect to collars will be applied prospectively, except in cases to prevent abuse. The legislative history states that, under the regulations to be issued by the Treasury, either a taxpayer's appreciated financial position or an offsetting transaction may in certain circumstances be considered on a disaggregated basis for purposes of the constructive sale determination. The Joint Committee on Taxation Report clarified that this authority is intended to be used only where such disaggregated treatment reflects the economic reality of the transaction and is administratively feasible. For example, one transaction for which disaggregated treatment might be appropriate is an equity swap that references a small group of stocks, where the transaction is entered into by a taxpayer owning only one of the stocks.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to "short sales" and "equity swaps."

This bill would conform California law to the TRA of 1997 federal change as it relates to recognition of gain on certain appreciated financial positions in personal property.

21. <u>Election of Mark-to-Market for Securities and Commodities Traders.</u>

Under **federal and California law**, a dealer in securities must compute its income pursuant to the mark-to-market method of accounting. Prior to the passage of the TRA of 1997, mark-to-market treatment did not apply to traders in securities or dealers in other property.

The TRA of 1997 allows securities traders and commodities traders and dealers to elect mark-to-market accounting treatment similar to that required for securities dealers. All securities held by an electing taxpayer in connection with a trade or business as a securities trader, and all commodities held by an electing taxpayer in connection with a trade or business as a commodities dealer or trader, are subject to mark-to-market treatment. Property not held in connection with its trade or business is not subject to the election provided that it is identified by the taxpayer under rules similar to the rules for securities dealers. An exception is provided for securities that have no connection with the taxpayer's activities as a trader and that are identified on the day acquired (or at such other times as provided in Treasury regulations). Gain or loss recognized by an electing taxpayer under the provision is ordinary gain or loss. Commodities for purposes of the provision would include only commodities of a kind customarily dealt in on an organized commodities exchange.

Similar rules apply to commodities traders. The TRA of 1997 expanded the definition of a commodity for purposes of the provision to include any commodity that is actively traded, any option, forward contract, futures contract, short position, notional principal contract or derivative instrument that references such a commodity, and any other evidence of an interest in such a commodity. Also included are positions that hedge the listed items and that are identified by the taxpayer under rules similar to the rules for securities. Congress anticipates that Treasury regulations applying IRC section 475(b)(4), which prevents a dealer from treating certain notional principal contracts and other derivative financial instruments as held for investment, will, in the case of a commodities trader or dealer, apply only to contracts and instruments referenced to commodities.

The Joint Committee on Taxation’s report states that Congress did not intend that an electing taxpayer can mark-to-market loans made to customers or receivables or debt instruments acquired from customers that are not received or acquired in connection with a trade or business as a securities trader. Because Congress was concerned about issues of taxpayer selectivity, Congress intended that an electing taxpayer must be able to demonstrate by clear and convincing evidence that a security bears no relation to a taxpayer’s activities as a trader in order to be identified as not subject to the mark-to-market regime. Any security that hedges another security that is held in connection with the taxpayer's trade or business as a trader will be treated as so held. Any position that is properly subject to the mark-to-market regime will not be taken into account for purposes of the constructive sale rules of IRC section 1259.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to mark-to-market method of accounting for security dealers.

This bill would conform California law to the TRA of 1997 federal change as it relates to mark-to-market method of accounting for securities and commodities traders

22. <u>Limitation on Exception for Investment Companies under IRC Section 351.</u>

Under federal and state law, a contribution of property to a corporation does not result in immediate gain or loss recognition to the shareholder contributor if that contributor is part of a group of contributors who have 80% control of the corporation. However, gain or loss is recognized upon a contribution by a shareholder to a corporation that is an investment company. Gain, but not loss, is recognized upon a contribution by a partner to a partnership that would be treated as an investment company. Under Treasury regulations, a contribution of property is treated as made to an investment company only if (1) the contribution results, directly or indirectly, in a diversification of the transferor's interest and (2) the transferee is (a) a regulated investment company (RIC), (b) a real estate investment trust (REIT) or, (c) prior to the passage of the TRA of 1997, a corporation more than 80% of the assets of which by value (excluding cash and non-convertible debt instruments) are readily marketable stocks or securities or interests in RICs or REITs that are held for investment

The **TRA of 1997** modified the definition of an investment company by requiring that the following assets also be taken into account for purposes of the 80% test: money, financial instruments, foreign currency, and interests in RICs, REITs, common trust funds, publicly-traded partnerships and precious metals. The TRA of 1997 provides an exception for precious metals that are produced, used or held in an active trade or business. The TRA of 1997 also provides for "look through" rules for certain entities that hold the above-listed items. The TRA of 1997 also provides the Treasury with regulatory authority to remove items from the list in appropriate circumstances.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to contributions to "investment companies".

This bill would conform California law to the TRA of 1997 federal change as it relates to the definition of an investment company.

23. <u>Gains and Losses from Certain Terminations with Respect to Property.</u>

Under **federal and state law**, the definition of capital gains and losses in IRC section 1222 requires a "sale or exchange" of a capital asset. Prior to the passage of the TRA of 1997, court decisions interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss.

The **TRA of 1997** extended to all types of property that is a capital asset in the hands of the taxpayer the rule that treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation as a capital asset in the hands of the taxpayer as gain or loss from the sale of a capital asset.

The **TRA of 1997** also repealed the provision that exempts debt obligations issued by natural persons from the rule which treats gain realized on retirement of the debt as sold or exchanged. Thus, gain or loss on the retirement of such debt will be capital gain or loss if the debt is a capital asset. The TRA of 1997 retains the present-law exceptions for debt issued before July 2, 1982, by noncorporations or nongovernments.

In addition, the **TRA of 1997** provided that if a taxpayer enters into a short sale of property and such property becomes substantially worthless, the taxpayer shall recognize gain as if the short sale were closed when the property becomes substantially worthless. The TRA of 1997 also extends the statute of limitations with respect to such gain recognition to the earlier of: (1) three years after the Secretary of the Treasury is notified that the position has become substantially worthless; or (2) six years after the date of filing of the income tax return for the taxable year during which the position became substantially worthless. To the extent provided in Treasury regulations, similar gain recognition rules shall apply to any option with respect to property, any offsetting notional principal contract with respect to property, any futures or forward contract to deliver property, or with respect to any similar transaction or position that becomes substantially worthless.

No inference was intended as to the proper treatment of these or similar transactions or positions prior to the passage of the TRA of 1997.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to the extinguishment rule.

This bill would conform California law to the TRA of 1997 federal change as it relates to gains and losses from certain terminations with respect to property.

24. Determination of Original Issue Discount Where Pooled Debt Obligations are Subject to Acceleration.

Under **federal and state law**, a taxpayer generally must include in gross income the amount of interest received or accrued within the taxable year on indebtedness held by the taxpayer. If the principal amount of an indebtedness may be paid without interest by a specified date (as is the case with certain credit card balances), the holder of the indebtedness is not required to accrue interest until after the specified date has passed.

Additionally, under **federal and state law**, the holder of a debt instrument with original issue discount (OID) generally accrues and includes in gross income, as interest, the OID over the life of the obligation, even though the interest may not be received until the maturity of the instrument. Special rules for determining the amount of OID allocated to a period apply to certain instruments that may be subject to prepayment. First, if a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt. In addition, in the case of (1) any regular interest in a real estate mortgage investment conduit (REMIC), (2) qualified mortgages held by a REMIC, or (3) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, the daily portions of the OID on such debt instruments are determined by taking into account an assumption regarding the prepayment of principal for such instruments.

The **TRA of 1997** applies the special OID rule applicable to any regular interest in a REMIC, qualified mortgages held by a REMIC, or certain other debt instruments to any pool of debt instruments the yield on which may be reduced by reason of prepayments. Thus, under the TRA of 1997, if a taxpayer holds a pool of credit card receivables that require interest to be paid if the borrowers do not pay their accounts by a specified date, the taxpayer would be required to accrue interest or OID on such pool based upon a reasonable assumption regarding the timing of the payments of the accounts in the pool. In addition, the Secretary of the Treasury is authorized to provide appropriate exemptions from the provision, including exemptions for taxpayers that hold a limited amount of debt instruments, such as small retailers.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to OID income.

This bill would conform California law to the TRA of 1997 federal change as it relates to determination of certain OID.

25. Deny Interest Deduction on Certain Debt Instruments.

Under **federal and state law**, whether an instrument qualifies for tax purposes as debt or equity is determined under all the facts and circumstances based on principles developed in case law. If an instrument qualifies as equity, the issuer generally does not receive a deduction for dividends paid and the holder generally includes such dividends in income (although corporate holders generally may obtain a dividends-received deduction). If an instrument qualifies as debt, the issuer may receive a deduction for accrued interest, and the holder generally includes the interest in income, subject to certain limitations.

OID on a debt instrument is the excess of the stated redemption price at maturity over the issue price of the instrument. An issuer of a debt instrument with OID generally accrues and deducts the discount as interest over the life of the instrument even though interest may not be paid until the instrument matures. The holder of such a debt instrument also generally includes the OID in income on an accrual basis.

Under **TRA of 1997**, no deduction is allowed for interest or OID on an instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that is payable in stock of the issuer or certain related parties, including an instrument a substantial portion of which is mandatorily convertible or convertible at the issuer’s option into stock of the issuer or a related party. In addition, an instrument is to be treated as payable in stock if a substantial portion of the principal or interest is required to be determined, or may be determined at the option of the issuer or related party, by reference to the value of stock of the issuer or related party. An instrument also is treated as payable in stock if it is part of an arrangement designed to result in such payment of the instrument with or by reference to such stock, such as in the case of certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder’s option when it is substantially certain that the right will be exercised.

For example, it is not expected that the provision will affect debt with a conversion feature where the conversion price is significantly higher than the market price of the stock on the issue date of the debt. The TRA of 1997 does not affect the treatment of a holder of an instrument. The TRA of 1997 is not intended to affect the characterization of instruments as debt or equity under present law.

California law is in conformity with federal law as it read on January 1, 1997, as it relates to interest deductions.

This bill would conform California law to the TRA of 1997 federal change as it relates to the denial of interest deductions on certain debt instruments.

26. Require Gain Recognition for Certain Extraordinary Dividends.

Under **federal law**, a corporate shareholder generally can deduct at least 70% of a dividend received from another C corporation. This dividends received deduction is 80% if the corporate shareholder owns at least 20% of the distributing corporation and generally 100% if the shareholder owns at least 80% of the distributing corporation. IRC section 1059 requires a corporate shareholder that receives an “extraordinary dividend” to reduce the basis of the stock with respect to which the dividend was received by the non-taxed portion of the dividend. Whether a dividend is “extraordinary” is determined, among other things, by reference to the size of the dividend in relation to the adjusted basis of the shareholder's stock. Also, a dividend resulting from a non pro rata redemption or a partial liquidation is an extraordinary dividend. If the reduction in basis of stock exceeds the basis in the stock with respect to which an extraordinary dividend is received, the excess is taxed as gain on the sale or disposition of such stock, but not until that time. The reduction in basis for this purpose occurs immediately before any sale or disposition of the stock. The Treasury Department has general regulatory authority to carry out the purposes of this IRC section.

Except as provided in regulations, the extraordinary dividend provisions do not apply if they result in a double reduction in basis in the case of distributions between members of an affiliated group filing consolidated returns where the dividend is eliminated or excluded under the consolidated return regulations. Double inclusion of earnings and profits (i.e., from both the dividend and from gain on the disposition of stock with a reduced basis) also should generally be prevented. Treasury regulations provide for application of the provision when a corporation is a partner in a partnership that receives a distribution.

In general, a distribution in redemption of stock is treated as a dividend, rather than as a sale of the stock, if it is essentially equivalent to a dividend. A redemption of the stock of a shareholder generally is essentially equivalent to a dividend if it does not result in a meaningful reduction in the shareholder's proportionate interest in the distributing corporation. IRC section 302(b) also contains several specific tests (e.g., a substantial reduction in interest computation and a complete termination of interest test) to identify redemptions that are not essentially equivalent to dividends. The determination whether a redemption is essentially equivalent to a dividend includes reference to the constructive ownership rules. The rules relating to treatment of cash or other property received in a reorganization contain a similar reference.

Under the **TRA of 1997**, except as provided in regulations, a corporate shareholder recognizes gain immediately with respect to any redemption treated as a dividend (in whole or in part) when the non-taxed portion of the dividend exceeds the basis of the shares surrendered, if the redemption is treated as a dividend due to options being counted as stock ownership. Thus, for example, where a portion of such a distribution would not have been treated as a dividend due to insufficient earnings and profits, the rule applies to the portion treated as a dividend. In addition, the TRA of 1997 requires immediate gain recognition whenever the basis of stock with respect to which any extraordinary dividend was received is reduced below zero. The reduction in basis of stock would be treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates.

Reorganizations or other exchanges involving amounts that are treated as dividends under IRC section 356 are treated as redemptions for purposes of applying the rules relating to redemptions under IRC section 1059(e). For example, if a recapitalization or other transaction that involves a dividend under IRC section 356 has the effect of a non pro rata redemption or is treated as a dividend due to options being counted as stock, the rules of IRC section 1059 apply. Redemptions of shares, or other extraordinary dividends on shares, held by a partnership will be subject to IRC section 1059 to the extent there are corporate partners (e.g., appropriate adjustments to the basis of the shares held by the partnership and to the basis of the corporate partner's partnership interest will be required).

The Treasury Department is authorized to issue regulations where necessary to carry out the purposes and prevent the avoidance of these provisions.

California law provides for deduction of a portion of the dividends received during the year declared from income which has been included in the measure of tax for California franchise, corporate income or alternative minimum tax purposes. Special rules apply for dividends received from insurance company subsidiaries and dividends received by taxpayers with a water's edge election in effect.

California law is in conformity with federal law as it read on January 1, 1997, as it relates to the treatment of extraordinary dividends and adjustments tothe basis of the subsidiary's stock with respect to extraordinary dividends.

This bill would conform California law to the TRA of 1997 federal change as it relates to the tax treatment of certain extraordinary dividends.

27. Require Gain Recognition on Certain Distributions of Controlled Corporation Stock (Morris Trust Transaction).

Under **federal and state law**, a corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) as if such property had been sold for its fair market value. The shareholders generally treat the receipt of property as a taxable event as well. An exception to this rule provides for, among other transactions, certain "spin-off" type distributions of stock of a controlled corporation, provided that various requirements are met.

Under federal law, the **TRA of 1997** adopts additional restrictions on acquisitions and dispositions of the stock of the distributing or controlled corporation.

Under the TRA of 1997, if either the controlled or distributing corporation is acquired pursuant to a plan or arrangement in existence on the date of distribution, gain is recognized as of the date of the distribution.

In the case of an acquisition of either the distributing corporation or the controlled corporation, the amount of gain recognized is the amount that the distributing corporation would have recognized had the stock of the controlled corporation been sold for fair market value on the date of the distribution. Such gain is recognized immediately before the distribution and is treated as long-term capital gain. No adjustment to the basis of the stock or assets of either corporation is allowed by reason of the recognition of the gain. The committee reports indicate that there is no intention to limit the otherwise applicable Treasury regulatory authority. There is also no intention to limit the otherwise applicable provisions of IRC section 1367 with respect to the effect on shareholder stock basis of gain recognized by an S corporation under this provision.

Whether a corporation is acquired is determined under rules similar to those of IRC section 355(d), except that acquisitions would not be restricted to “purchase” transactions. Thus, an acquisition occurs if one or more persons acquire 50% or more of the vote or value of the stock of the controlled or distributing corporation pursuant to a plan or arrangement. For example, assume a corporation (“P”) distributes the stock of its wholly-owned subsidiary (“S”) to its shareholders in a transaction that otherwise qualifies as a IRC section 355 spin-off. If, pursuant to a plan or arrangement, 50% or more of the vote or value of either P or S is acquired by one or more persons, the TRA of 1997 requires gain recognition by the distributing corporation. Except as provided in Treasury regulations, if the assets of the distributing or controlled corporation are acquired by a successor in a merger or other transaction under IRC section 368(a)(1)(A), (C) or (D), the shareholders (immediately before the acquisition) of the corporation acquiring such assets are treated as acquiring stock in the corporation from which the assets were acquired. Under Treasury regulations, other asset transfers also could be subject to this rule.

Certain aggregation and attribution rules apply for determining whether one or more persons has acquired a 50% or greater interest in the distributing or controlled corporation. The aggregation rules of IRC section 355(d)(7)(A) apply. In addition, except as provided in regulations, IRC section 318(a)(2)(C) applies without regard to the amount of stock ownership of the corporation.

A public offering of sufficient size can result in an acquisition that causes gain recognition under the TRA of 1997 provision.

Acquisitions occurring within the four-year period beginning two years before the date of distribution and ending two years after the date of distribution are presumed to have occurred pursuant to a plan or arrangement. Taxpayers can avoid gain recognition by showing that an acquisition occurring during this four-year period was unrelated to the distribution.

The Treasury Department is authorized to prescribe regulations necessary to carry out the purposes of the provision, including regulations to provide for the application of the changes made by the TRA of 1997 in the case of multiple transactions.

Certain Transactions Not Considered Acquisitions.

Under the **TRA of 1997**, certain specific types of transactions do not cause gain recognition or are not treated as acquisitions for purposes of determining whether there has been an acquisition of a 50% or greater interest in the distributing or the controlled corporation.

Single Affiliated Group.

Under the TRA of 1997, a plan (or series of related transactions) is not one that will cause gain recognition if, immediately after the completion of such plan or transactions, the distributing corporation and all controlled corporations are members of a single affiliated group of corporations (as defined in IRC section 1504 without regard to subsection (b) thereof).

Example 1: P corporation is a member of an affiliated group of corporations that includes subsidiary corporation S and subsidiary corporation S1. P owns all the stock of S. S owns all the stock of S1. P corporation is merged into unrelated X corporation in a transaction in which the former shareholders of X corporation will own 50% or more of the vote or value of the stock of surviving X corporation after the merger. As part of the plan of merger, the stock of S1 will be distributed by S to X in a transaction that otherwise qualifies under IRC section 355. After this distribution, S, S1, and X will remain members of a single affiliated group of corporations under IRC section 1504 (without regard to whether any of the corporations is a foreign corporation, an insurance company, a tax exempt organization, or an electing IRC section 936 company). Even though there has been an acquisition of P, S, and S1 by X, and a distribution of S1 by S that is part of a plan or series of related transactions, the plan is not treated as one that requires gain recognition on the distribution of S1 to X. This is because the distributing corporation S and the controlled corporation S1 remain within a single affiliated group after the distribution (even though the P group has changed ownership).

Continuing Direct or Indirect Ownership.

Under the **TRA of 1997**, except as provided in Treasury regulations, certain acquisitions are not taken into account in determining whether a 50% or greater interest in the distributing or controlled corporation has been acquired. Generally, in any transaction, stock received directly or indirectly by former shareholders of the distributing or controlled corporation, in a successor or new controlling corporation of either, is not treated as acquired stock if it is attributable to such shareholders' stock in the distributing or controlled corporation that was not acquired as part of a plan or arrangement to acquire 50% or more of such successor or other corporation.

IRC section 355(e)(3)(A)(iv), as originally enacted, provided that an acquisition does not require gain recognition if the same persons own 50% or more of both corporations, directly or indirectly before and after the acquisition and distribution, provided the stock owned before the acquisition was not acquired as part of a plan (or series of related transactions) to acquire a 50% or greater interest in either the distributing or controlled corporation.

Example 2: Individual A owns all the stock of P corporation. P owns all the stock of a subsidiary corporation, S. Subsidiary S is distributed to individual A in a transaction that otherwise qualifies under IRC section 355. As part of a plan, P then merges with corporation X, also owned entirely by individual A. There is not an acquisition that requires gain recognition under the provision, because individual A owns directly or indirectly 100% of all the stock of both X, the successor to P, and S before and after the transaction. The example assumes that A did not acquire his or her stock in P as part of a plan or series of related transactions that results in the direct or indirect ownership of 50% or more of S or P separately by A. If A's stock in P was acquired as part of such a plan, the transaction would be one requiring gain recognition on the spin-off of S. The same result would occur if P were contributed to a holding company, all the stock of which is owned by A.

Example 3: Assume the facts are the same as in Example 2 except that corporations P and X are each owned by the same 20 individual 5% shareholders (rather than wholly by individual A). The transaction described in Example 2, in which S is spun off by P to P’s shareholders and P is acquired by X, would not cause gain recognition, because each shareholder that owned stock of the distributing and controlled corporation before the transaction continues to own the same percentage of stock of each corporation after the transaction.

Example 4: Shareholder A owns 10% of the vote and value of the stock of corporation D (which owns all of corporation C). There are nine other equal shareholders of D. A also owns 100% of the vote and value of the stock of unrelated corporation P. D distributes C stock pro rata to all the shareholders of D. Thereafter, pursuant to a plan or series of related transactions, D (worth 100x) merges with corporation P (worth 900x). After the merger, each of the former shareholders of corporation D owns stock of the merged entity reflecting the vote and value attributable to that shareholder’s respective 10% former stock ownership in D. Each of the former shareholders of D owns 1% of the stock of the merged corporation, except that shareholder A (who owned 100% of corporation P and 10% of corporation D before the merger) now owns 91% of the stock of the merged corporation. In determining whether a 50% or greater interest in D has been acquired, the interest of each of the continuing shareholders is disregarded only to the extent there has been no decrease in such shareholder’s direct or indirect ownership. Thus, the 10% interest of A, and the 1% interest of each of the nine other former shareholders of D, is not counted. The remaining 81% ownership of the merged corporation, representing a decrease of 9% in the interests of each of the nine former shareholders other than A, is counted in determining the extent of an acquisition. Therefore, a 50% or greater interest in D has been acquired resulting in IRC section 355(e)(3)(A)(iv) to apply.

Except as provided in Treasury regulations, certain other acquisitions also are not taken into account. For example, the following other types of acquisitions of stock are not subject to the provision, provided that the stock owned before the acquisition was not acquired pursuant to a plan or series of related transactions to acquire a 50% or greater ownership interest in either distributing or controlled corporation:

First, the acquisition of stock in the controlled corporation by the distributing corporation (as one example, in the case of a contribution of property by the distributing corporation to the controlled corporation in exchange for the stock of the controlled corporation);

Second, the acquisition by a person of stock in any controlled corporation by reason of holding stock or securities in the distributing corporation (as one example, the receipt by a distributing corporation shareholder of controlled corporation stock in a distribution--including a split-off distribution in which a shareholder that did not own 50% of the stock of distributing owns 50% or more of the stock of the controlled corporation); and

Third, the acquisition by a person of stock in any successor corporation of the distributing corporation or any controlled corporation by reason of holding stock or securities in such distributing or controlled corporation (for example, the receipt by former shareholders of the distributing corporation of 50% or more of the stock of a successor corporation in a merger involving the distributing).

The TRA of 1997 does not apply to distributions that would otherwise be subject to IRC section 355(d), which imposes corporate level tax on certain disqualified distributions.

The TRA of 1997 does not apply to a distribution pursuant to a title 11 or similar case.

IRC section 355(f).

The **TRA of 1997** provides that, except as provided in Treasury regulations, IRC section 355 (or so much of IRC section 356 as relates to IRC section 355) shall not apply to the distribution of stock from one member of an affiliated group of corporations (as defined in IRC section 1504(a)) to another member of such group (an “intragroup spin-off”) if such distribution is part of a plan (or series of related transactions) described in IRC section 355(e)(2)(A)(ii), pursuant to which one or more persons acquire directly or indirectly stock representing a 50% or greater interest in the distributing corporation or any controlled corporation.

Example 5: P corporation owns all the stock of subsidiary corporation S. S owns all the stock of subsidiary corporation T. S distributes the stock of T corporation to P as part of a plan or series of related transactions in which P then distributes the S stock to its shareholders and then P is merged into unrelated X corporation. After the merger, former shareholders of X corporation own 50% or more of the voting power or value of the stock of the merged corporation. Because the distribution of T by S is part of a plan or series of related transactions in which S is distributed by P outside the P affiliated group and P is then acquired under IRC section 355(e), IRC section 355 in its entirety does not apply to the intragroup spin-off of T to P under IRC section 355(f). Also, the distribution of S by P is subject to IRC section 355(e).

In determining whether an acquisition described in subsection 355(e)(2)(A)(ii) occurs, all the new provisions of IRC section 355(e) are applied. For example, an intragroup spin-off in connection with an overall transaction that does not cause gain recognition under IRC section 355(e) because it is described in IRC section 355(e)(2)(C), or because of IRC section 355(e)(3), or because of the effective date of IRC section 355(e), is not subject to the rule of IRC section 355(f).

The Treasury Department has regulatory authority to vary the result that the intragroup distribution under IRC section 355(f) does not qualify for IRC section 355 treatment. In this connection, the Treasury Department could by regulation eliminate some or all of the gain recognition required under IRC section 355(f) in connection with the issuance of regulations that would cause appropriate basis results with respect to the stock of S and T in the above example so that concerns regarding present law IRC section 355 basis rules (described below in connection with IRC section 358(c)) would be eliminated.

Treasury Regulatory Authority

The **TRA of 1997** provides that in the case of any distribution of stock of one member of an affiliated group of corporations to another member under IRC section 355 (“intragroup spin-off”), the Secretary of the Treasury is authorized under IRC section 358(g) to provide adjustments to the basis of any stock in a corporation which is a member of such group, to reflect appropriately the proper treatment of such distribution. It is understood that the approach of any such regulations applied to intragroup spin-offs that do not involve an acquisition may also be applied under the Treasury regulatory authority to modify the rule of IRC section 355(f) as may be appropriate.

Congress believed that the concerns relating to basis adjustments in the case of intragroup spin-offs are essentially similar, regardless of whether an acquisition is currently intended as part of a plan or series of related transactions. The concerns include the following:

First, under present law consolidated return regulations, it is possible that an excess loss account of a lower tier subsidiary may be eliminated. This creates the potential for the subsidiary to leave the group without recapture of the excess loss account, even though the group has benefited from the losses or distributions in excess of basis that led to the existence of the excess loss account.

Second, under present law, a shareholder’s stock basis in its stock of the distributing corporation is allocated after a spin-off between the stock of the distributing and controlled corporations, in proportion to the relative fair market values of the stock of those companies. If a disproportionate amount of asset basis (as compared to value) is in one of the companies (including but not limited to a shift of value and basis through a borrowing by one company and contribution of the borrowed cash to the other), present law rules under IRC section 358(c) can produce an increase in stock basis relative to asset basis in one corporation, and a corresponding decrease in stock basis relative to asset basis in the other company. Because the spin-off has occurred within the corporate group, the group can continue to benefit from high inside asset basis either for purposes of sale or depreciation, while also choosing to benefit from the disproportionately high stock basis in the other corporation. If, for example, both corporations were sold at a later date, a prior distribution can result in a significant decrease in the amount of gain recognized that would have occurred if the two corporations had been sold together without a prior spin-off (or separately, without a prior spin-off).

Example 6: P owns all the stock of S1 and S1 owns all the stock of S2. P’s basis in the stock of S1 is 50; the inside asset basis of S1’s assets is 50; and the total value of S1’s stock and assets (including the value of S2) is 150. S1’s basis in the stock of S2 is 0; the inside basis of S2’s assets is 0; and the value of S2’s stock and assets is 100. If S1 were sold, holding S2, the total gain would be 100. S1 distributes S2 to P in a IRC section 355 transaction. After this spin-off, under present law, P’s basis in the stock of S1 is approximately 17 (50/150 times the total 50 stock basis in S1 prior to the spin-off) and the inside asset basis of S1 is 50. P’s basis in the stock of S2 is 33 (100/150 times the total 50 stock basis in S1 prior to the spin-off) and the inside asset basis of S2 is 0. After a period of time, S2 can be sold for its value of 100, with a gain of 67 rather than 100. Also, since S1 remains in the corporate group, the full 50 inside asset basis can continue to be used. S1’s assets could be sold for 50 with no gain or loss. Thus, S1 and S2 can be sold later at a total gain of 67, rather than the total gain of 100 that would have occurred had they been sold without the spin-off.

As one variation on the foregoing concern, taxpayers have attempted to utilize spin-offs to extract significant amounts of asset value and basis (including but not limited to transactions in which one corporation decreases its value by incurring debt, and increases the asset basis and value of the other corporation by contributing the proceeds of the debt to the other corporation) without creation of an excess loss account or triggering of gain, even when the extraction is in excess of the basis in the distributing corporation's stock.

The Treasury Department may promulgate any regulations necessary to address these concerns and other collateral issues. As one example, the Treasury Department may consider providing rules that require a carryover basis within the group (or stock basis conforming to asset basis as appropriate) for the distributed corporation (including a carryover of an excess loss account, if any, in a consolidated return). Similarly, the Treasury Department may provide a reduction in the basis of the stock of the distributing corporation to reflect the change in the value and basis of the distributing corporation's assets. The Treasury Department may determine that the aggregate stock basis of the distributing and controlled corporation after the distribution may be adjusted to an amount that is less than the aggregate basis of the stock of the distributing corporation before the distribution, to prevent inappropriate potential for artificial losses or diminishment of gain on disposition of any of the corporations involved in the spin-off. The Treasury Department may provide separate regulations for corporations in affiliated groups filing a consolidated return and for affiliated groups not filing a consolidated return, as appropriate to each situation.

Control Requirement for Certain Transactions.

The TRA of 1997 also modifies certain rules for determining control immediately after a distribution in the case of certain divisive transactions in which a controlled corporation is distributed and the transaction meets the requirements of IRC section 355. In such cases, under IRC section 351 and modified IRC section 368(a)(2)(H) with respect to certain reorganizations under IRC section 368(a)(1)(D), those shareholders receiving stock in the distributed corporation are treated as in control of the distributed corporation immediately after the distribution if they hold stock representing a greater than 50% interest in the vote and value of stock of the distributed corporation.

The TRA of 1997 does not change the requirement under IRC section 355 that the distributing corporation must distribute 80% of the voting power and 80% of each other class of stock of the controlled corporation. It is expected that this requirement will be applied by the Internal Revenue Service taking account of the provisions of the TRA of 1997 regarding plans that permit certain types of planned restructuring of the distributing corporation following the distribution, and to treat similar restructurings of the controlled corporation in a similar manner. Thus, the 80% control requirement is expected to be administered in a manner that would prevent the tax-free spin-off of a less-than-80% controlled subsidiary, but generally would not impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to distributions of controlled corporations except that it does not recognize consolidated return authority.

This bill would conform California law to the TRA of 1997 federal changes as it relates to certain distributions of controlled corporation stock, except in the application of consolidated return rules.

28. Reform Tax Treatment of Certain Corporate Stock Transfers.

Under **prior federal and current state law**, if one corporation purchases stock of a related corporation, the transaction generally is recharacterized as a redemption. In determining whether a transaction so recharacterized is treated as a sale (thereby generating capital gain or loss) or a dividend, reference is made to the changes in the selling corporation’s ownership of stock in the issuing corporation (applying the constructive ownership rules of IRC section 318(a) with modifications). Sales proceeds received by a corporate transferor that are characterized as a dividend may qualify for the dividends-received deduction.

The above rule does not apply to transfers of stock between members of a consolidated group. Section 1059 applies to “extraordinary dividends,” including certain redemption transactions treated as dividends qualifying for the dividends-received deduction. If a redemption results in an extraordinary dividend, IRC section 1059 generally requires the shareholder to reduce its basis in the stock of the redeeming corporation by the non-taxed portion of such dividend.

Under the **TRA of 1997**, to the extent that a IRC section 304 transaction is treated as a distribution under IRC section 301, the transferor and the acquiring corporation are treated as if (1) the transferor had transferred the stock involved in the transaction to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which IRC section 351(a) applies, and (2) the acquiring corporation had then redeemed the stock it is treated as having issued. Thus, the acquiring corporation is treated for all purposes as having redeemed the stock it is treated as having issued to the transferor. In addition, the TRA of 1997 amends IRC section 1059 so that, if the IRC section 304 transaction is treated as a dividend to which the dividends received deduction applies, the dividend is treated as an extraordinary dividend in which only the basis of the transferred shares would be taken into account under IRC section 1059.

A special rule applies to transactions involving acquisitions by foreign corporations. The TRA of 1997 limits the earnings and profits of the acquiring foreign corporation that are taken into account. The earnings and profits of the acquiring foreign corporation to be taken into account will not exceed the portion of such earnings and profits that (1) is attributable to stock of such acquiring corporation held by a corporation or individual who is the transferor (or a person related thereto) and who is a U.S. shareholder (within the meaning of IRC section 951(b)) of such corporation, and (2) was accumulated during periods in which such stock was owned by such person while such acquiring corporation was a controlled foreign corporation. For purposes of this rule, except as otherwise provided by the Secretary of the Treasury, the rules of IRC section 1248(d) (relating to certain exclusions from earnings and profits with respect to foreign corporations) would apply. The Secretary of the Treasury is to prescribe regulations as appropriate, including regulations determining the earnings and profits that are attributable to particular stock of the acquiring corporation.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to corporate stock transfers, except with respect to application of IRC section 1248.

This bill would conform California law to the TRA of 1997 federal change as it relates to certain corporate stock transfers.

29. Treat Certain Preferred Stock as "Boot".

Under **prior federal and current state law**, in reorganization transactions qualifying under IRC section 368 and certain other restructurings, gain or loss is recognized only to the extent "other property" (called "boot") is received, that is, property other than certain stock, including preferred stock. Thus, preferred stock could be received tax-free in a reorganization. Upon the receipt of "other property," gain (or in some instances loss) can be recognized. A special rule permits debt securities to be received tax-free, but only to the extent debt securities of no lesser principal amount are surrendered in the exchange. Other than this securities-for-securities rule, similar rules generally apply to transactions under IRC section 351.

The **TRA of 1997** amended the relevant provisions to treat certain preferred stock as "other property" (i.e., "boot") subject to certain exceptions. Thus, when a taxpayer exchanges property for this preferred stock in a transaction that qualifies under either IRC section 351, 355, 368, or 1036, gain (or in some instances loss) is recognized.

The **TRA of 1997** applies to preferred stock (i.e., stock that is limited and preferred as to dividends and does not participate, including through a conversion privilege, in corporate growth to any significant extent), where (1) the holder has the right to require the issuer or a related person (within the meaning of sections 267(b) and 707(b)) to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer (or a related person) has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices, regardless of whether such varying rate is provided as an express term of the stock (for example, in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (for example, in the case of auction rate stock). For this purpose, the rules of (1), (2), and (3) apply if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.

In addition, if neither the stock surrendered nor the stock received in the exchange is stock of a corporation any class of stock of which (or of a related corporation) is publicly traded, a right or obligation is disregarded if it may be exercised only upon the death, disability, or mental incompetence of the holder. Also, a right or obligation is disregarded in the case of stock transferred in connection with the performance of services if it may be exercised only upon the holder's separation from service.

The following exchanges are excluded from this gain recognition requirement: (1) certain exchanges of preferred stock for comparable preferred stock of the same or lesser value; (2) an exchange of preferred stock for common stock; (3) certain exchanges of debt securities for preferred stock of the same or lesser value; and (4) exchanges of stock in certain recapitalizations of family-owned corporations. For this purpose, a family-owned corporation is defined as any corporation if at least 50% of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50% of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family are defined by reference to the definition in IRC section 447(e). Thus, a family includes children, parents, brothers, sisters, and spouses, with limited attribution rules for directly and indirectly owned stock of the corporation. Shares held by a family member are treated as not held by a family member to the extent a non-family member had a right, option or agreement to acquire the shares (directly or indirectly, for example, through redemptions by the issuer), or with respect to shares as to which a family member has reduced its risk of loss with respect to the shares, for example, through an equity swap. Even though the provision excepts certain family recapitalizations, the special valuation rules of IRC section 2701 for estate and gift tax purposes continue to apply. An exchange of nonqualified preferred stock for nonqualified preferred stock in an acquiring corporation may qualify for tax-free treatment under IRC section 354, but not IRC section 351.

In cases in which both sections 354 and 351 may apply to a transaction, IRC section 354 generally will apply for purposes of this provision. Thus, in that situation, the exchange would be tax free.

The **TRA of 1997** also clarifies the treatment of certain conversion or exchange rights, by deleting any statutory reference to the existence of a "conversion privilege." The conferees wish to clarify that in no event will a conversion privilege to convert stock into stock of the issuer automatically be considered to constitute participation in corporate growth to any significant extent.

The Joint Committee on Taxation report also clarifies that stock that is convertible or exchangeable into stock of a corporation other than the issuer (including, for example, stock of a parent corporation or other related corporation) is not considered to be stock that participates in corporate growth to any significant extent for purposes of the provision.

The Treasury Secretary has regulatory authority to (1) apply installment sale-type rules to preferred stock that is subject to this proposal in appropriate cases and (2) prescribe treatment of preferred stock subject to this provision under other provisions of the Code (e.g., sections 304, 306, 318, and 368(c)). Until regulations are issued, preferred stock that is subject to the proposal shall continue to be treated as stock under other provisions of the code.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to "boot" received in a reorganization.

This bill would conform California law to the TRA of 1997 federal change as it relates to the treatment of certain preferred stock as "boot".

30. Modify Holding Period for Dividends-Received Deduction.

Under **prior federal and current state law**, the dividends-received deduction is allowed to a corporate shareholder only if the shareholder satisfies a 46-day holding period for the dividend-paying stock (or a 91-day period for certain dividends on preferred stock). The 46 or 91 day holding period generally does not include any time in which the shareholder is protected from the risk of loss otherwise inherent in the ownership of an equity interest. The holding period must be satisfied only once, rather than with respect to each dividend received.

The **TRA of 1997** provides that a taxpayer is not entitled to a dividends-received deduction if the taxpayer's holding period for the dividend-paying stock is not satisfied over a period immediately before or immediately after the taxpayer becomes entitled to receive the dividend.

California law is similar to federal law as it read on January 1, 1997, as it relates to the dividends received deduction with modification to reflect state apportionment rules. California law provides for the elimination of a portion of the dividends received during the year that are paid from income which has been previously included in the measure of tax for California franchise, corporate or alternative tax purposes. Special rules apply for dividends received from insurance company subsidiaries and dividends received by taxpayers making a water's-edge election.

This bill would conform California law to the TRA of 1997 federal change as it relates to holding period for the dividends-received deduction.

31. Reporting of Certain Payments Made to Attorneys.

Under **federal and state law,** information reporting generally is required by persons engaged in a trade or business and making payments in the course of that trade or business of "rent, salaries, wages, or other fixed or determinable gains, profits, and income" (miscellaneous payments). Thus, attorney's fees are required to be reported if they are for legal services paid by a person in a trade or business in the course of that trade or business. Treasury regulation IRC section 1.6041-3(c) generally exempts payments made to corporations from the 1099-MISC information reporting requirement.

Information returns are also required of every person doing business as a broker, as defined. This reporting is regarding gross proceeds and done on Form 1099B.

The IRS has a combined information return filing program. Under this program, IRS copies the information returns and sends the information via magnetic media to the particular state designated by the person filing the information return. To simplify filing requirements for California payers and because a copy of the IRS information return can be filed as a substitute for California purposes, FTB participates in the IRS combined information return filing program. However, the IRS has excepted several types of information returns from the combined filing program, such as the information returns of brokers. For certain information returns that are filed on paper, IRS has agreed to scan those Form 1099s and send to FTB by magnetic media the information on all California payees.

Additionally, the IRS and FTB have a reciprocal exchange of information program to share IRS records for tax administration purposes.

The **TRA of 1997** requires gross proceeds reporting on all payments to attorneys, including professional corporations, in connection with legal services made by a trade or business in the course of that trade or business. It is anticipated that gross proceeds reporting would be required on Form 1099B (used by brokers to report gross proceeds). In addition, payments made by a trade or business to any person, including professional corporations, for legal services must be reported on the 1099-MISC (even though previously under the Treasury regulation IRC section 1.6041-3(c) the reporting of such payments made to corporations would otherwise have been exempt). The only exception to the new reporting requirement under IRC section 6045 would be for payments reported on either Form 1099-Misc under IRC section 6041 (reports of payment of income) or on Form W-2 under IRC section 6051 (payments of wages).

California law in general conforms to the federal law, prior to the passage of the TRA of 1997, regarding the requirement to file information returns by "stand alone" provisions that pertain to the particular type of information return required, including the miscellaneous information returns. In most cases the "stand alone" California law allows a copy of the federal information return to satisfy California's filing requirements. Although FTB participates in the IRS's combined information return filing program, because brokers are excepted from the combined federal program, brokers must file either on magnetic media with FTB or a paper document that will be scanned by IRS, unless the payer is out of state or the reported amounts differ for federal and state purposes, in which case the paper document is processed by FTB. In addition, FTB uses the IRS reciprocal exchange of information agreement to receive IRS information return records for tax administration purposes. Without the express authority that authorizes FTB to require a particular type of information return, it is unclear whether FTB may clearly rely on the reciprocal agreement to obtain IRS information return records.

This bill would conform California law to the TRA of 1997 federal change as it relates to reporting requirements of certain payments made to attorneys.

32. Returns of Beneficiaries of Estates and Trusts.

Under **federal and state law**, an S corporation is required to file a return for the taxable year and is required to furnish to its shareholders a copy of certain information shown on such return. The shareholder is required to file its return in a manner that is consistent with the information received from the S corporation, unless the shareholder files with the Secretary of the Treasury a notification of inconsistent treatment. For federal purposes similar rules apply in the case of partnerships and their partners.

Additionally, under **federal and state law**, the fiduciary of an estate or trust that is required to file a return for any taxable year is required to furnish to beneficiaries certain information shown on such return (generally via a Schedule K-1). Additionally under federal law, a U.S. person that is treated as the owner of any portion of a foreign trust is required to ensure that the trust files a return for the taxable year and furnishes certain required information to each U.S. person who is treated as an owner of a portion of the trust or who receives any distribution from the trust.

Under the TRA of 1997, the beneficiaries and owners of the above referenced trusts are required to file their returns in a manner that is consistent with the information received from the estate or trust, unless the beneficiary files with its return a notification of inconsistent treatment identifying the inconsistency.

California law in concept conforms to the federal requirement that informational or tax returns be filed by entities that pass income items through to other persons. For S corporations and shareholders, California conforms to the federal law that requires shareholders to report consistently with the treatment of items on the S corporation tax return, unless the inconsistency is reported on a statement attached to the return. Under the conformed S corporation law, any unreported inconsistencies are treated as a math error. California has not conformed for purposes of partnerships and trusts.

California law does not have specific provisions for foreign trusts.

This bill would conform California law to the TRA of 1997 federal change as it relates to the consistency requirements applicable to beneficiaries of estates and trusts.

33. <u>Registration and Penalties For Confidential Corporate Tax Shelters.</u>

Under **federal and state law**, an organizer of a tax shelter is required to register the shelter with the IRS and/or FTB. If the principal organizer does not do so, the duty may fall upon any other participant in the organization of the shelter or any person participating in its sale or management. The shelter's identification number must be furnished to each investor who purchases or acquires an interest in the shelter. Failure to furnish this number to the tax shelter investors will subject the organizer to a $100 penalty for each such failure. A penalty may be imposed against an organizer who fails without reasonable cause to timely register the shelter or who provides false or incomplete information with respect to it. The penalty is the greater of 1% of the aggregate amount invested in the shelter or $500. Persons claiming any tax benefit with respect to a shelter must report its registration number on their returns. Failure to do so without reasonable cause will subject a person to a $250 penalty.

A person who organizes or sells an interest in a tax shelter subject to the registration rule or in any other potentially abusive plan or arrangement must maintain a list of the investors. A $50 penalty may be assessed for each name omitted from the list. The maximum penalty per year is $100,000. For this purpose, a tax shelter is defined as any investment that meets two requirements. First, the investment must be (1) required to be registered under a federal or state law regulating securities, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a federal or state agency regulating the offering or sale of securities, or (3) a substantial investment. Second, it must be reasonable to infer that the ratio of deductions and 50% of credits to investment for any investor (i.e., the tax shelter ratio) may be greater than two to one as of the close of any of the first five years ending after the date on which the investment is offered for sale. An investment that meets these requirements will be considered a tax shelter regardless of whether it is marketed or customarily designated as a tax shelter.

Accuracy-Related Penalty.

The accuracy-related penalty, which is imposed at a rate of 20%, applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. The substantial understatement penalty applies in the following manner: If the correct income tax liability of a taxpayer for a taxable year exceeds that reported by the taxpayer by the greater of 10% of the correct tax or $5,000 ($10,000 in the case of most corporations), then a substantial understatement exists and a penalty may be imposed equal to 20% of the underpayment of tax attributable to the understatement. In determining whether a substantial understatement exists, the amount of the understatement is reduced by any portion attributable to an item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there was a reasonable basis for the tax treatment of the item. Special rules apply to tax shelters.

With respect to tax shelter items of non-corporate taxpayers, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for his position, he reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters. The reduction in the understatement for items disclosed on the return is inapplicable to both corporate and non-corporate tax shelters. For this purpose, a tax shelter is a partnership or other entity, plan, or arrangement the principal purpose of which is the avoidance or evasion of Federal income tax. The Secretary may waive the penalty with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith.

Under the **TRA of 1997**, a promoter of a corporate tax shelter must register the shelter with the Secretary of the Treasury. Registration is required not later than the next business day after the day when the tax shelter is first offered to potential investors. If the promoter is not a U.S. person, or if a required registration is not otherwise made, then any U.S. participant is required to register the shelter. An exception to this special rule provides that registration would not be required if the U.S. participant notifies the promoter in writing not later than 90 days after discussions began that the U.S. participant will not participate in the shelter and the U.S. person does not in fact participate in the shelter.

Under the TRA of 1997, a corporate tax shelter includes any investment, plan, arrangement or transaction (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant, (2) that is offered to any potential participant under conditions of confidentiality, and (3) for which the tax shelter promoters may receive total fees in excess of $100,000. A transaction is offered under conditions of confidentiality if: (1) an offeree (or any person acting on its behalf) has an understanding or agreement with or for the benefit of any promoter to restrict or limit its disclosure of the transaction or any significant tax features of the transaction; or (2) the promoter claims, knows or has reason to know (or the promoter causes another person to claim or otherwise knows or has reason to know that a party other than the potential offeree claims) that the transaction (or one or more aspects of its structure) is proprietary to the promoter or any party other than the offeree, or is otherwise protected from disclosure or use. For this purpose, the "promoter" includes specified related parties.

Registration requires the submission of information identifying and describing the tax shelter and the tax benefits of the tax shelter, as well as such other information as the Treasury Department may require.

Tax shelter promoters are required to maintain lists of those who have signed confidentiality agreements, or otherwise have been subjected to nondisclosure requirements, with respect to particular tax shelters. In addition, promoters must retain lists of those paying fees with respect to plans or arrangements that have previously been registered (even though the particular party may not have been subject to confidentiality restrictions).

All registrations will be treated as taxpayer information under the provisions of IRC section 6103 and will therefore not be subject to any public disclosure.

The penalty for failing to timely register a corporate tax shelter is the greater of $10,000 or 50% of the fees payable to any promoter with respect to offerings prior to the date of late registration (i.e., this part of the penalty does not apply to fee payments with respect to offerings after late registration). A similar penalty is applicable to actual participants in any corporate tax shelter who were required to register the tax shelter but did not. With respect to participants, however, the 50% penalty is based only on fees paid by that participant. Intentional disregard of the requirement to register by either a promoter or a participant increases the 50% penalty to 75% of the applicable fees.

Substantial Understatement Penalty.

In determining whether a substantial understatement exists, the TRA of 1997 amendment provides that in no event would a corporation have a reasonable basis for its tax treatment of an item attributable to a multi-party financing transaction if such treatment does not clearly reflect the income of the corporation. No inference is intended that such a multi-party financing transaction could not also be a tax shelter as defined under the modification described below or under present law. Additionally the TRA of 1997 amendments, for purposes of the special rules to determine whether there is a significant underpayment by a tax shelter, changes the definition of a tax shelter to be consistent with the registration provisions for tax shelters so that it is an entity the significant purpose (rather than principal purpose) of which is the avoidance or evasion of federal income tax.

Treasury Report.

The Treasury Department is directed, in consultation with the Department of Justice, to issue a report no later than August 5, 1998, to the tax-writing committees on the following tax shelter issues: (1) a description of enforcement efforts under IRC section 7408 (relating to actions to enjoin promoters of abusive tax shelters) with respect to corporate tax shelters and the lawyers, accountants, and others who provide opinions (regardless of whether directly addressed to the taxpayer) regarding aspects of corporate tax shelters; (2) an evaluation of whether the penalties regarding corporate tax shelters are generally sufficient; and (3) an evaluation of whether confidential tax shelter registration should be extended to transactions where the investor (or potential investor) is not a corporation.

California law conforms to the pre-TRA of 1997 law treatment for the purposes of registration requirements for tax shelters, the filing of information returns and the significant underpayment penalty via “stand-alone” provisions that make reference to the relevant federal law sections.

This bill would conform California law to the TRA of 1997 federal change as it relates to the registration and penalties for confidential corporate tax shelters. The requirements for registration are deemed complied with if the taxpayer complies with federal law.

34. <u>Extend UBIT Rules to Second-Tier Subsidiaries and Amend Control Test.</u>

Under **prior federal and current state law**, interest, rents, royalties and annuities are generally excluded from unrelated business taxable income (UBI) of tax-exempt organizations. However, special rules treat otherwise excluded rent, royalty, annuity, and interest income as UBI if such income is received from a certain taxable or tax-exempt subsidiary that is 80%-controlled by the parent tax-exempt organization. In the case of a stock subsidiary, the 80% control test is met if the parent organization owns 80% or more of the voting stock and all other classes of stock of the subsidiary. In the case of a non-stock subsidiary, the applicable Treasury regulations look to factors such as the representation of the parent corporation on the board of directors of the nonstock subsidiary, or the power of the parent corporation to appoint or remove the board of directors of the subsidiary.

Additionally, under **prior federal and current state law**, rent, royalty, annuity, and interest payments are treated as UBI when received by the parent organization based on the percentage of the subsidiary's income that is UBTI (either in the hands of the subsidiary if the subsidiary is tax-exempt, or in the hands of the parent organization if the subsidiary is taxable).

The “control test” under IRC section 512(b)(13) does not, however, incorporate any indirect ownership rules. PLR 9338003 (June 16, 1993) held that because no indirect ownership rules are applicable under IRC section 512(b)(13), rents paid by a second-tier taxable subsidiary are not UBI to a tax-exempt parent organization. In contrast, an example of an indirect ownership rule can be found in section 318(a)(2)(C), which provides that if 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly by or for such corporation, in the proportion the value of the person's stock ownership bears to the total value of all stock in the corporation. Consequently, rents, royalties, annuities and interest derived from second-tier subsidiaries generally do not constitute UBI to the tax-exempt parent organization. PLR 9542045 (July 28, 1995) held that a first-tier holding company and a second-tier operating subsidiary were organized with bona fide business functions and were not agents of the tax-exempt parent organization; therefore, rents, royalties, and interest received by the tax-exempt parent organization from second-tier subsidiary were not UBI.

The **TRA of 1997** modifies the test for determining control for purposes of IRC section 512(b)(13). Under the TRA of 1997, "control" means (in the case of a stock corporation) ownership by vote or value of more than 50% of the stock. In the case of a partnership or other entity, control means ownership of more than 50% of the profits, capital or beneficial interests. In addition, the TRA of 1997 applies the constructive ownership rules of IRC section 318 for purposes of IRC section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50% of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second or lower-tier subsidiary).

The TRA of 1997 also makes technical modifications to the method provided in IRC section 512(b)(13) for determining how much of an interest, rent, annuity, or royalty payment made by a controlled entity to a tax-exempt organization is includible in the latter organization's UBI. Such payments are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to UBI of tax-exempt organizations.

This bill would conform California law to the TRA of 1997 federal change as it relates to the extension of UBI rules to second-tier subsidiaries and the control test.

35 <u>Allocation of Basis Among Properties Distributed by Partnership.</u>

Under **prior federal and current state law**, the partnership provisions generally permit partners to receive distributions of partnership property without recognition of gain or loss. Rules are provided for determining the basis of the distributed property in the hands of the distributee and for allocating basis among multiple properties distributed, as well as for determining adjustments to the distributee partner's basis in its partnership interest. Property distributions are tax-free to a partnership. Adjustments to the basis of the partnership's remaining undistributed assets are not required unless the partnership has made an election that requires basis adjustments both upon partnership distributions and upon transfers of partnership interests. Exceptions to this nonrecognition rule (partners receive distributions of partnership property without recognition of gain or loss) apply: (1) when money (and the fair market value of marketable securities) received exceeds a partner's adjusted basis in the partnership; (2) when only money, inventory and unrealized receivables are received in liquidation of a partner's interest and loss is realized; (3) to certain disproportionate distributions involving inventory and unrealized receivables; and (4) to certain distributions relating to contributed property. In addition, if a partner engages in a transaction with a partnership other than in its capacity as a member of the partnership, the transaction generally is considered as occurring between the partnership and one who is not a partner.

Also, **prior federal and current state law** provides two different rules for determining a partner's basis in distributed property, depending on whether the distribution is in liquidation of the partner's interest in the partnership. Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction).

By contrast, a carryover basis rule generally applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap. Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed.

In the event that multiple properties are distributed by a partnership, **Prior federal and current state law** provide allocation rules for determining their bases in the distributee partner's hands. An allocation rule is needed when the substituted basis rule for liquidating distributions applies in order to assign a portion of the partner's basis in its partnership interest to each distributed asset. An allocation rule is also needed in a non-liquidating distribution of multiple assets when the total carryover basis would exceed the partner's basis in its partnership interest, so a portion of the partner's basis in its partnership interest is assigned to each distributed asset.

Prior federal and current state law also provide for allocation in proportion to the partnership's adjusted basis. The rule allocates basis first to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis (or if the allocated basis is less than partnership basis, then in proportion to the partnership's basis), and then among other properties in proportion to their adjusted bases to the partnership. Under this allocation rule, in the case of a liquidating distribution, the distributee partner can have a basis in the distributed property that exceeds the partnership's basis in the property.

A special rule allows a partner that acquired a partnership interest by transfer within two years of a distribution to elect to allocate the basis of property received in the distribution as if the partnership had a IRC section 754 election in effect. The special rule also allows the IRS to require such an allocation where the value at the time of transfer of the property received exceeds 110% of its adjusted basis to the partnership.

The **TRA of 1997** modified the basis allocation rules for distributee partners. It allocates a distributee partner's basis adjustment among distributed assets first to unrealized receivables and inventory items in an amount equal to the partnership's basis in each such property (as under prior federal law). If the basis to be allocated is less than the sum of the adjusted bases of the properties to the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal the total basis to be allocated, the decrease is allocated as described below for adjustments that are decreases.

Basis is allocated first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective fair market values. For example, assume that a partnership with two assets, A and B, distributes them both in liquidation to a partner whose basis in its interest is 55. Neither asset consists of inventory or unrealized receivables. Asset A has a basis to the partnership of 5 and a fair market value of 40, and asset B has a basis to the partnership of 10 and a fair market value of 10. Under the provision, basis is first allocated to asset A in the amount of 5 and to asset B in the amount of 10 (their adjusted bases to the partnership). The remaining basis adjustment is an increase totaling 40 (the partner's 55 basis minus the partnership's total basis in distributed assets of 15). Basis is then allocated to asset A in the amount of 35, its unrealized appreciation, with no allocation to asset B attributable to unrealized appreciation because its fair market value equals the partnership's adjusted basis. The remaining basis adjustment of 5 is allocated in the ratio of the assets' fair market values, i.e., 4 to asset A (for a total basis of 44) and 1 to asset B (for a total basis of 11).

If the remaining basis adjustment is a decrease, it is allocated among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation), and then in proportion to their respective adjusted bases (taking into account the adjustments already made). A remaining basis adjustment that is a decrease arises under the provision when the partnership's total adjusted basis in the distributed properties exceeds the amount of the partner's basis in its partnership interest, and the latter amount is the basis to be allocated among the distributed properties.

For example, assume that a partnership with two assets, C and D, distributes them both in liquidation to a partner whose basis in its partnership interest is 20. Neither asset consists of inventory or unrealized receivables. Asset C has a basis to the partnership of 15 and a fair market value of 15, and asset D has a basis to the partnership of 15 and a fair market value of 5. Under the TRA of 1997, basis is first allocated to the extent of the partnership's basis in each distributed property, or 15 to each distributed property, for a total of 30. Because the partner's basis in its interest is only 20, a downward adjustment of 10 (30 minus 20) is required. The entire amount of the 10 downward adjustment is allocated to property D, reducing its basis to 5. Thus, the basis of property C is 15 in the hands of the distributee partner, and the basis of property D is 5 in the hands of the distributee partner.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to partnership distributions.

This bill would conform California law to the TRA of 1997 federal change as it relates to the allocation of basis among properties distributed by partnership.

36. Repeal of Requirement Inventory be Substantially Appreciated with Respect to Disposition of Partnership Interest.

Under **prior federal and current state law**, upon the sale or exchange of a partnership interest, any amount received that was attributable to unrealized receivables, or to inventory that had substantially appreciated, was treated as an amount realized from the sale or exchange of property that was not a capital asset.

Present and prior law provides a similar rule to the extent that a distribution is treated as a sale or exchange of a partnership interest. A distribution by a partnership in which a partner receives substantially appreciated inventory or unrealized receivables in exchange for its interest in certain other partnership property (or receives certain other property in exchange for its interest in substantially appreciated inventory or unrealized receivables) is treated as a taxable sale or exchange of property, rather than as a nontaxable distribution.

For purposes of these rules, inventory of a partnership generally is treated as substantially appreciated if the fair market value of the inventory exceeds 120% of the adjusted basis of the inventory to the partnership. In applying this rule, inventory property is excluded from the calculation if a principal purpose for acquiring the inventory property was to avoid the rules relating to inventory.

The **TRA of 1997** repeals the requirement that inventory be substantially appreciated in order to give rise to ordinary income in the case of sales or exchanges of partnership interests under IRC section 751(a), but not with respect to distributions under IRC section 751(b). Thus, present law is retained with respect to distributions governed by IRC section 751(b).

IRC section 751(a) relates to sale or exchanges of partnership interest. IRC section 751(b) relates to “certain distributions treated as sales or exchanges” (e.g., disproportionate distributions).

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to partnership distributions of substantially appreciated inventory.

This bill would conform California law to the TRA of 1997 federal change as it relates to the requirement that inventory be substantially appreciated to be considered a “hot asset”.

37. Extension of Time for Taxing Pre-Contribution Gain.

Under **present federal and state law**, if a partner contributes appreciated property to a partnership, no gain is recognized to the contributing partner at the time of the contribution. The contributing partner's basis in its partnership interest is increased by the basis of the contributed property at the time of the contribution. The pre-contribution gain is reflected in the difference between the partner's capital account and its basis in its partnership interest (book/tax differential). Income, gain, loss, and deduction with respect to the contributed property must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution. **Under prior federal law and current state law** if the property is subsequently distributed to another partner within five years of the contribution, the contributing partner generally recognizes gain as if the property had been sold for its fair market value at the time of the distribution. Similarly, the contributing partner generally includes pre-contribution gain in income to the extent that the value of other property distributed by the partnership to that partner exceeds its adjusted basis in its partnership interest, if the distribution by the partnership is made within five years after the contribution of the appreciated property.

The **TRA of 1997** extends to seven years the period during which a partner recognizes pre-contribution gain with respect to property contributed to a partnership. Thus, under the provision, a partner that contributes appreciated property to a partnership generally recognizes pre-contribution gain in the event that the partnership distributes the contributed property to another partner, or distributes to the contributing partner other property whose value exceeds that partner's basis in its partnership interest, if the distribution occurs within seven years after the contribution to the partnership.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to contributions of appreciated property to partnerships and the five year pre-contribution gain period.

This bill would conform California law to the TRA of 1997 federal change as it relates to the time for taxing pre-contribution gain from the contribution of appreciated property to a partnership.

38. Cashout of Certain Accrued Benefits.

Under **prior federal and current state law**, in the case of an employee whose retirement plan participation terminates, a qualified plan may involuntarily "cash out" the benefit (i.e., pay out the balance to the credit of a plan participant without the participant's consent and, if applicable, the consent of the participant's spouse) if the present value of the benefit did not exceed $3,500. If a benefit is cashed out under this rule and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which benefits were cashed out unless the employee "buys back" the benefit.

Generally, a cash-out distribution from a qualified plan to a plan participant can be rolled over, tax free, to an IRA or to another qualified plan.

The TRA of 1997 increased the limit on involuntary cash outs from $3,500 to $5,000. The $5,000 amount is adjusted for inflation beginning after 1998 in $50 increments.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to involuntary cash out distributions from pension plans.

This bill would conform California law to the TRA of 1997 federal change as it relates to the cash out of certain accrued benefits.

39. <u>Taxable Cash Compensation in lieu of Nontaxable Parking Benefits.</u>

Under **present federal and state law**, up to $170 per month of employer-provided parking is excludable from gross income. Under **prior federal and current state law**, in order for the exclusion to apply, the parking must be provided in addition to and not in lieu of any compensation that is otherwise payable to the employee. Employer-provided parking cannot be provided as part of a cafeteria plan.

Under the **TRA of 1997** no amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and employer-provided parking. The amount of cash offered is includible in income only if the employee chooses the cash instead of parking.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to employer-provided parking benefits. An additional exclusion is available for compensation or benefits received for participation in a ridesharing arrangement.

This bill would conform California law to the TRA of 1997 federal change as it relates to the taxability of parking benefits.

40. <u>Basis Recovery Rules for Annuities Over More Than One Life.</u>

Under **present federal and state law**, amounts received as an annuity under a tax-qualified pension plan generally are includible in income in the year received, except to the extent the amount received represents return of the recipient's investment in the contract (i.e., basis). The portion of each annuity payment that represents a return of basis generally is determined by a simplified method. Under this method, the portion of each annuity payment that is a return of basis is equal to the employee's total basis as of the annuity starting date, divided by the number of anticipated payments under a "specified table." The number of anticipated payments listed in the table is based on the age of the primary annuitant on the annuity starting date.

Under the **TRA of 1997**, the prior federal specified table applies to benefits based on the life of one annuitant. A separate table applies to benefits based on the life of more than one annuitant.

Combined age of annuitants	Number of payments
Not more than 110	410
More than 110 but not more than 120	360
More than 120 but not more than 130	310
More than 130 but not more than 140	260
More than 140	210

The TRA of 1997 clarifies that the new table applies to benefits based on the life of more than one annuitant, even if the amount of the annuity varies by annuitant. Thus, for example, the new table applies to a 50% joint and survivor annuity. The new table does not apply to an annuity paid on a single life merely because it has additional features, e.g., a term certain.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the taxable portion of an annuity. Due to past differences in amounts excluded or deducted from income, state and federal amounts subject to tax may be different.

This bill would conform California law to the TRA of 1997 federal change as it relates to the basis recovery of annuities. The past differences in amounts may still cause the amounts to be different.

41. Denial of Deduction for Certain Amounts Paid in Connection with Insurance.

Federal and state income tax generally is not imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup). This favorable tax treatment is available only if the policyholder has an insurable interest in the insured when the contract is issued and if the life insurance contract meets certain requirements designed to limit the investment character of the contract. Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract; such distributions generally are treated first as a tax-free recovery of basis, and then as income. In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10% tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances.

A modified endowment contract is a life insurance contract that does not meet a statutory "seven-pay" test, i.e., generally is funded more rapidly than seven annual level premiums. An exclusion from federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured. Further, certain amounts received under a life insurance contract on the life of a terminally or chronically ill individual, and certain amounts paid for the sale or assignment to a viatical settlement provider of a life insurance contract on the life of a terminally ill or chronically ill individual, are treated as excludable as if paid by reason of the death of the insured. Further, an exclusion from federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.

No deduction is permitted for premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

Present **federal and state** law provides generally that no deduction is allowed for interest paid or accrued on any indebtedness with respect to one or more life insurance contracts or annuity or endowment contracts owned by the taxpayer covering any individual who is or was (1) an officer or employee of, or (2) financially interested in, any trade or business currently or formerly carried on by the taxpayer (the “COLI” rules).

This interest deduction disallowance rule generally does not apply to interest on debt with respect to contracts purchased on or before June 20, 1986; rather, an interest deduction limit based on Moody's Corporate Bond Yield Average-Monthly Average Corporates applies in the case of such contracts. Phase-in rules apply generally with respect to otherwise deductible interest paid or accrued after December 31, 1995, and before January 1, 1999, in the case of debt incurred before January 1, 1996. In addition, transition rules apply.

An exception to this interest disallowance rule is provided for interest on indebtedness with respect to life insurance policies covering up to 20 key persons. A key person is an individual who is either an officer or a 20% owner of the taxpayer. The number of individuals who can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of 5% of the total number of officers and employees of the taxpayer, or 20 individuals. For determining who is a 20% owner, all members of a controlled group are treated as one taxpayer. Interest paid or accrued on debt with respect to a contract covering a key person is deductible only to the extent the rate of interest does not exceed Moody's Corporate Bond Yield Average-Monthly Average Corporates for each month beginning after December 31, 1995, that interest is paid or accrued. The foregoing interest deduction limitation was added in 1996 to existing interest deduction limitations with respect to life insurance and similar contracts.

Present **federal law** provides that no deduction is allowed for interest on debt incurred or continued to purchase or carry obligations the interest on which is wholly exempt from federal income tax. In addition, in the case of a financial institution, a proration rule provides that no deduction is allowed for that portion of the taxpayer's interest that is allocable to tax-exempt interest. The portion of the interest deduction that is disallowed under this rule generally is the portion determined by the ratio of the taxpayer's (1) average adjusted bases of tax-exempt obligations acquired after August 7, 1986, to (2) the average adjusted bases for all of the taxpayer's assets. Special rules apply for certain tax-exempt obligations of small issuers.

Under the **TRA of 1997**, the prior federal law premium deduction limitation is modified to provide that no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.

The premium deduction limitation does not apply to premiums with respect to any annuity contract described in IRC section 72(s)(5) (relating to certain qualified pension plans, certain retirement annuities, individual retirement annuities, and qualified funding assets), or to premiums with respect to any annuity to which IRC section 72(u) applies (relating to current taxation of income on the contract in the case of an annuity contract held by a person who is not a natural person).

Under TRA of 1997, no deduction is allowed for interest paid or accrued on any indebtedness with respect to a life insurance policy, or endowment or annuity contract, covering the life of any individual. Thus, the provision limits interest deductibility in the case of such a contract covering any individual in whom the taxpayer has an insurable interest when the contract is first issued under applicable state law when the contract is first issued, except as otherwise provided under existing federal law with respect to key persons and pre-1986 contracts.

The **TRA of 1997** specifies the treatment of certain interest to which the provision providing for expansion of interest disallowance to individuals in whom ataxpayer has an insurable interest otherwise would apply. The conference agreement provides that in the case of a transfer for valuable consideration of a life insurance contract or any interest therein described in IRC section 101(a)(2), the amount of the death benefit excluded from gross income under IRC section 101(a) may not exceed an amount equal to the sum of the actual value of the consideration, premiums, interest disallowed as a deduction under new IRC section 264(a)(4), and other amounts subsequently paid by the transferee. Thus, under the provision, in the case of the transfer for value of a life insurance contract, the interest with respect to the contract that otherwise would be disallowed under new IRC section 264(a)(4) is capitalized, reducing the amount included in income by the transferee upon receipt by the transferee of the amounts paid by reason of the death of the insured.

In the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values with respect to any life insurance policy or annuity or endowment contract issued after June 8, 1997. Interest expense is so allocable based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, to (2) the sum of (a) in the case of assets that are life insurance policies or annuity or endowment contracts, the average unborrowed policy cash values, and (b) in the case of other assets, the average adjusted bases for all such other assets of the taxpayer.

This rule does not apply to any policy or contract owned by an entity engaged in a trade or business covering an individual who is an employee, officer or director of the trade or business at the time first covered. Under the conference agreement, the exception applies to any policy or contract owned by an entity engaged in a trade or business which covers one individual who (at the time first insured under the policy or contract) is (1) a 20% owner of the entity, or (2) an individual (who is not a 20% owner) who is an officer, director or employee of the trade or business. The exception also applies in the case of a joint-life policy or contract under which the sole insureds are a 20% owner and the spouse of the 20% owner.

A joint-life contract under which the sole insureds are a 20% owner and his or her spouse is the only type of policy or contract with more than one insured that comes within the exception. Thus, for example, if the insureds under a contract include an individual described in the exception (e.g., an employee, officer, director, or 20% owner) and any individual who is not described in the exception (e.g., a debtor of the entity), then the exception does not apply to the policy or contract. For purposes of this exception, a 20% owner has the same meaning as under present-law IRC section 264(d)(4). In addition, the **TRA of 1997** provides that the pro rata interest disallowance rule does not apply to any annuity contract to which IRC section 72(u) applies (relating to current taxation of income on the contract in the case of an annuity contract held by a person who is not a natural person). The **TRA of 1997** provides that any policy or contract that is not subject to the pro rata interest disallowance rule by reason of this exception (for 20% owners, their spouses, employees, officers and directors, and in the case of an annuity contract to which IRC section 72(u) applies) is not taken into account in applying the ratio to determine the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values.

The unborrowed policy cash values means the cash surrender value of the policy or contract determined without regard to any surrender charge, reduced by the amount of any loan with respect to the policy or contract. The cash surrender value is to be determined without regard to any other contractual or noncontractual arrangement that artificially depresses the cash value of a contract.

If a trade or business (other than a sole proprietorship or a trade or business of performing services as an employee) is directly or indirectly the beneficiary under any policy or contract, then the policy or contract is treated as held by the trade or business. For this purpose, the amount of the unborrowed cash value is treated as not exceeding the amount of the benefit payable to the trade or business. In the case of a partnership or S corporation, the provision applies at the partnership or corporate level. The amount of the benefit is intended to take into account the amount payable to the business under the contract (e.g., as a death benefit) or pursuant to another agreement (e.g., under a split dollar agreement). The amount of the benefit is intended also to include any amount by which liabilities of the business would be reduced by payments under the policy or contract (e.g., when payments under the policy reduce the principal or interest on a liability owed to or by the business).

As provided in regulations, the issuer or policyholder of the life insurance policy or endowment or annuity contract is required to report the amount of the amount of the unborrowed cash value in order to carry out this rule.

If interest expense is disallowed under other provisions of IRC section 264 (limiting interest deductions with respect to life insurance policies or endowment or annuity contracts) or under IRC section 265 (relating to tax-exempt interest), then the disallowed interest expense is not taken into account under this provision, and the average adjusted bases of assets is reduced by the amount of debt, interest on which is so disallowed. The provision is applied before present-law rules relating to capitalization of certain expenses where the taxpayer produces property.

An aggregation rule is provided treating related persons as one for purposes of the provision. The aggregation rule is intended to prevent taxpayers from avoiding the pro rata interest limitation by owning life insurance, endowment or annuity contracts, while incurring interest expense through an related person.

The provision does not apply to any insurance company subject to tax under subchapter L of the IRC. Rather, the rules reducing certain deductions for losses incurred in the case of property and casualty companies, and reducing reserve deductions or dividends-received deductions of life insurance companies, are modified to take into account the increase in cash values of life insurance policies or annuity or endowment contracts held by insurance companies. For purposes of those rules, an increase in the policy cash value for any policy or contract is (1) the amount of the increase in the adjusted cash value, reduced by (2) the gross premiums received with respect to the policy or contract during the taxable year, and increased by (3) distributions under the policy or contract to which IRC section 72(e) apply (other than amounts includable in the policyholder's gross income). For this purpose, the adjusted cash value means the cash surrender value of the policy or contract, increased by (1) commissions payable with respect to the policy or contract for the taxable year, and (2) asset management fees, surrender and mortality charges, and any other fees or charges, specified in regulations, which are imposed (or would be imposed if the policy or contract were surrendered or canceled) with respect to the policy or contract for the taxable year.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to interest expense relating to insurance contracts. Additionally, under the B&CTL no deduction is allowed for expenses incurred in connection with "wholly" or "partially" exempt income.

This bill would conform California law to the TRA of 1997 federal change as it relates to certain payments in connection with insurance.

42. Limitation on Property for which Income Forecast Method May be Used.

Under **federal law**, a taxpayer generally recovers the cost of property used in a trade or business through depreciation or amortization deductions over time. Tangible property generally is depreciated under the Modified Accelerated Cost Recovery System (MACRS), which applies specific recovery periods and depreciation methods to the cost of various types of depreciable property. MACRS does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer applies a unit-of-production method or other method of depreciation not expressed in a term of years. The cost of such property may be depreciated under the "income forecast" method.

The income forecast method is considered to be a method of depreciation not expressed in a term of years. Under the income forecast method, the depreciation deduction for a taxable year for a property is determined by multiplying the cost of the property (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year and the denominator of which is the total forecasted or estimated income to be derived from the property during its useful life. The income forecast method may be used if (1) the taxpayer elects to exclude such property from MACRS and (2) for the first taxable year for which depreciation is allowable, the property is properly depreciated under such method. The income forecast method has been held to be applicable for computing depreciation deductions for motion picture films, television films and taped shows, books, patents, master sound recordings and video games. Most recently, the income forecast method has been held applicable to consumer durable property subject to short-term "rent-to-own" leases.

The **TRA of 1997** clarifies the types of property to which the income forecast method may be applied. The income forecast method is available to motion picture films, television films and taped shows, books, patents, master sound recordings, copyrights, and other such property as designated by the Secretary of the Treasury. The mere fact that the property is subject to a lease should not make the property eligible for the income forecast method. The income forecast method is not to be applicable to property to which IRC section 197 applies.

In addition under the TRA of 1997, consumer durables subject to rent-to-own contracts are provided a three-year recovery period and a four-year class life for MACRS purposes (and are not eligible for the income forecast method). Such property generally is described in Rev. Proc. 95-38. In addition, the special three-year recovery period may apply to any property generally used in the home for personal, but not business, use. The committee reports indicate that Congress understands that certain rent-to-own property, including computer and peripheral equipment, may be used in the home for either personal or business purposes, and the taxpayer may not be aware of how its customers may use the property. So as not to increase the administrative burdens taxpayers, the conferees intend that if such dual-use property does not represent a significant portion of a taxpayer's leasing property and if such other leasing property predominantly is qualified rent-to-own property, then such dual-use property generally also would be qualified rent-to-own property. However, if such dual-use property represents a significant portion of the taxpayer's leasing property, the burden of proof is placed on the taxpayer to show that such property is qualified rent-to-own property. In addition, the **TRA of 1997** modifies the definition of "rent-to-own contract" to include leases that provide for decreasing regular periodic payments.

Finally, the **TRA of 1997** clarifies that the three-year recovery period provided under the provision only applies to property subject to leases, and the committee reports indicate that no inference is intended as to whether any arrangement constitutes a lease for tax purposes.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to the income forecast method of depreciation.

The PITL is conformed to MACRS depreciation. The B&CTL has not conformed to MACRS depreciation.

This bill would conform the PITL and B&CTL to the TRA of 1997 federal change as it relates to use of the income forecast method of depreciation. Under the B&CTL, this bill creates a special class life of four years for certain "rent-to-own property."

43. <u>Involuntarily Converted Property Acquired from an Unrelated Person.</u>

Under **federal law**, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified replacement period of time. Subchapter C corporations (and certain partnerships with corporate partners) are not entitled to defer gain under IRC section 1033 if the replacement property or stock is purchased from a related person. A person is treated as related to another person if the person bears a relationship to the other person described in IRC sections 267(b) or 707(b)(1). An exception to this related party rule provides that a taxpayer could purchase replacement property or stock from a related person and defer gain to the extent the related person acquired the replacement property or stock from an unrelated person within the replacement period.

The **TRA of 1997** expands the denial of the application of involuntary conversion tax treatment to any other taxpayer (including an individual) that acquires replacement property from a related party (as defined by sections 267(b) and 707(b)(1)) unless the taxpayer has aggregate realized gain of $100,000 or less for the taxable year with respect to converted property with aggregate realized gains. In the case of a partnership (or S corporation), the annual $100,000 limitation applies to both the partnership (or S corporation) and each partner (or shareholder).

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to qualified replacement property for involuntary converted property.

This bill would conform California law to the TRA of 1997 federal change as it relates to replacement property in involuntary conversions.

44. <u>Exception from Installment Sales Rules for Sales by a Manufacturer.</u>

Under **federal law**, the installment sales method of accounting may not be used by dealers in personal property. Present law provides an exception which permits the use of the installment method for installment obligations arising from the sale of tangible personal property by a manufacturer of the property (or an affiliate of the manufacturer) to a dealer (i.e., the sale of the property must be intended to be for resale or leasing by the dealer). The exception applies only if the dealer is obligated to make payments of principal only when the dealer resells (or rents) the property, the manufacturer has the right to repurchase the property at a fixed (or ascertainable) price after no longer than a nine-month period following the sale to the dealer, and certain other conditions are met. In order to meet the other conditions, the aggregate face amount of the installment obligations that otherwise qualify for the exception must equal at least 50% of the total sales to dealers that gave rise to such receivables (the “50% test”) in both the taxable year and the preceding taxable year, except that, if the taxpayer met all of the requirements for the exception in the preceding taxable year, the taxpayer would not be treated as failing to meet the 50% test before the second consecutive year in which the taxpayer did not actually meet the test. In addition, these requirements must be met by the taxpayer in its first taxable year beginning after October 22, 1986, except that obligations issued before that date are treated as meeting the applicable requirements if such obligations were conformed to the requirements of the provision within 60 days of that date.

The **TRA of 1997** repealed the exception that permits the use of the installment method of accounting for certain sales by manufacturers to dealers.

California law is in full conformity with federal law as it read on January 1, 1997, prior to the passage of the TRA of 1997, as it relates to installment sales.

This bill would conform California law to the TRA of 1997 federal change as it relates to the installment sales rules for certain sales by manufacturers to dealers.

45. Limitations on Charitable Remainder Trust Eligibility.

Under **federal law**, IRC sections 170(f), 2055(e)(2) and 2522(c)(2) disallow a charitable deduction for income, estate or gift tax purposes, respectively, where the donor transfers an interest in property to a charity (e.g., a remainder interest) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for: (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, pooled income funds, farms, and personal residences; (2) present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property; (3) an undivided portion of the donor's entire interest in the property; and (4) a qualified conservation easement.

A charitable remainder annuity trust is a trust which is required to pay a fixed dollar amount, not less often than annually, of at least 5% of the initial value of the trust to a non-charity for the life of an individual or for a period of years not to exceed 20 years, with the remainder passing to charity. A charitable remainder unitrust is a trust which generally is required to pay, at least annually, a fixed percentage of the fair market value of the trust's assets (determined at least annually) to a noncharity for the life of an individual or for a period of years not to exceed 20 years, with the remainder passing to charity. Distributions from a charitable remainder annuity trust or charitable remainder unitrust are treated first as ordinary income to the extent of the trust's current and previously undistributed ordinary income for the trust's year in which the distribution occurred; second, as capital gains to the extent of the trust's current capital gain and previously undistributed capital gain for the trust's year in which the distribution occurred; third, as other income (e.g., tax-exempt income) to the extent of the trust's current and previously undistributed other income for the trust's year in which the distribution occurred; and, fourth, as corpus. Distributions are includible in the income of the beneficiary for the year that the annuity or unitrust amount is required to be distributed even though the annuity or unitrust amount is not distributed until after the close of the trust's taxable year.

On April 18, 1997, the Treasury Department proposed regulations providing additional rules under sections 664 and 2702 to address perceived abuses involving distributions from charitable remainder trusts. One of those proposed rules would require that payment of any required annuity or unitrust amount by a charitable remainder trust (other than an "income only" unitrust) be made by the close of the trust's taxable year in which such payments are due. See Prop. Treas. Reg. sections 1.664-(a)(1)(i) and 1.664-(a)(1)(i).

Under the **TRA of 1997**, a trust cannot be a charitable remainder annuity trust if the annuity for any year is greater than 50% of the initial fair market value of the trust's assets or be a charitable remainder unitrust if the percentage of assets that are required to be distributed at least annually is greater than 50%. Any trust that fails this 50% rule will not be a charitable remainder trust whose taxation is governed under IRC section 664, but will be treated as a complex trust and, accordingly, all its income will be taxed to its beneficiaries or to the trust.

In addition, the value of the charitable remainder with respect to any transfer to a qualified charitable remainder annuity trust or charitable remainder unitrust is required to be at least 10% of the net fair market value of such property transferred in trust on the date of the contribution to the trust. The 10% test is measured on each transfer to the charitable remainder trust and, consequently, a charitable remainder trust which meets the 10% test on the date of transfer will not subsequently fail to meet that test if interest rates have declined between the trust's creation and the death of a measuring life. Similarly, where a charitable remainder trust is created for the joint lives of two individuals with a remainder to charity, the trust will not cease to qualify as a charitable remainder trust because the value of the charitable remainder was less than 10% of the trust's assets at the first death of those two individuals.

The **TRA of 1997** provides several additional rules in order to provide relief for trusts that do not meet the 10% rule. First, where a transfer is made after July 28, 1997, to a charitable remainder trust that fails the 10% test, the trust is treated as meeting the 10% requirement if the governing instrument of the trust is changed by reformation, amendment, construction, or otherwise to meet such requirement by reducing the payout rate or duration (or both) of any noncharitable beneficiary's interest to the extent necessary to satisfy such requirement so long as the reformation is commenced within the period permitted for reformations of charitable remainder trusts under IRC section 2055(e)(3). The statute of limitations applicable to a deficiency of any tax resulting from reformation of the trust shall not expire before the date one year after the Treasury Department is notified that the trust has been reformed. In substance, this rule relaxes the requirements of IRC section 2055(e)(3)(B) to the extent necessary for the reformation for the trust to meet the 10% requirement.

Second, a transfer to a trust will be treated as if the transfer never had been made where a court having jurisdiction over the trust subsequently declares the trust void (because, e.g., the application of the 10% rule frustrates the purposes for which the trust was created) and judicial proceedings to revoke the trust are commenced within the period permitted for reformations of charitable remainder trusts under IRC section 2055(e)(3). Under this provision, the effect of "unwinding" the trust is that any transactions made by the trust with respect to the property transferred (e.g., income earned on the assets transferred to the trust and capital gains generated by the sales of the property transferred) would be income and capital gain of the donor (or the donor's estate if the trust was testamentary), and the donor (or the donor's estate if the trust was testamentary) would not be permitted a charitable deduction with respect to the transfer. The statute of limitations applicable to a deficiency of any tax resulting from "unwinding" the trust shall not expire before the date one year after the Treasury Department is notified that the trust has been revoked.

Third, where an additional contribution is made after July 28, 1997, to a charitable remainder unitrust created before July 29, 1997, and that unitrust would not meet the 10% requirement with respect to the additional contribution, the conference agreement provides that such additional contribution will be treated, under regulations to be issued by the Secretary of the Treasury, as if it had been made to a new trust that does not meet the 10% requirement, but which does not affect the status of the original unitrust as a charitable remainder trust.

The committee reports indicated that Congress intends that this provision not limit or alter the validity of regulations proposed by the Treasury Department on April 18, 1997, or the Treasury Department's authority to address abuses of the rules governing the taxation of charitable remainder trusts or their beneficiaries.

California law is in full conformity with federal law as it read on January 1, 1997, as it relates to charitable remainder trusts.

This bill would conform California law to the TRA of 1997 federal change as it relates to limitations on charitable remainder trust eligibility.

46. Estimated Tax Requirements of Individuals.

Under prior **federal law**, an individual taxpayer generally was subject to an addition to tax for any underpayment of estimated tax. An individual generally did not have an underpayment of estimated tax if he or she made timely estimated tax payments at least equal to: (1) 100% of the tax shown on the return of the individual for the preceding year (the 100% of last year's liability safe harbor), or (2) 90% of the tax shown on the return for the current year. The 100% of last year's liability safe harbor was modified to be a 110% of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year.

For individual taxpayers with AGI greater than $150,000 ($75,000 if married filing a separate return), the **TRA of 1997** changed the 110% of last year's liability safe harbor to be a 100% of last year's liability safe harbor for taxable years beginning in 1998, a 105% of last year's liability safe harbor for taxable years beginning in 1999, 2000, and 2001, and a 112% of last year's liability safe harbor for taxable years beginning in 2002.

In addition, no estimated tax penalties will be imposed under sections 6654 or 6655 for any period before January 1, 1998, for any payment the due date of which is before January 16, 1998, with respect to any underpayment to the extent such underpayment is created or increased by a provision of the TRA of 1997.

Current **California law** conforms, in general, with federal rules relating to the payment of estimated tax by individuals. However, there are several significant differences:

- The "required payment" is based upon 80% of the current year tax instead of 90%.
- The "required payment" does not include alternative minimum tax.
- Estimated payments are required, unless the tax due for the year is less than $100.
- No penalty will be assessed if 80% of the current or prior year tax is subject to withholding.
- No penalty will be assessed if 80% of the adjusted gross income consists of wages subject to withholding.

- California requires taxpayers with AGI greater than $150,000 ($75,000 if married filing a separate return) to pay 110% of the preceding year's tax liability for 1997, 100% for 1998 and 110% thereafter to qualify under the preceding tax year exception to the underpayment of estimated tax penalty. This provision was enacted by SB 455 (Stat. 1997, Ch. 611). SB 455 also contained a waiver of estimated tax penalty provision if the estimated tax payment was due to a provision in SB 455. Thus, effectively, only 100% of the prior year's liability for the 1997 tax year needed to be paid to qualify for the exception.

This bill would conform California law to the TRA of 1997 federal change as it relates to the prior year exception from the estimated tax penalty. This bill would also provide that no estimate tax penalty would apply to any tax payment made before April 16, 1999, to the extent the underpayment was created or increased by a provision in this bill.

47. <u>Simplify Treatment of Personal Transactions in Foreign Currency.</u>

Under **federal law**, when a U.S. taxpayer makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") generally arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for federal income tax purposes. Exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss also can arise where foreign currency was acquired for personal use.

Under the **TRA of 1997**, if an individual acquires foreign currency and disposes of it in a personal transaction, and the exchange rate changes between the acquisition and disposition of such currency, nonrecognition treatment applies to any resulting exchange gain, provided that such gain does not exceed $200. The provision does not change the treatment of resulting exchange losses.

Transactions entered into in connection with a business trip constitute personal transactions for purposes of this provision. Exchange gain resulting from such transactions is eligible for nonrecognition treatment under this provision.

California law generally conforms to the federal treatment of certain foreign currency transactions, except as modified. However, California does not apply the source rules provided in IRC section 988(a).

This bill would conform California law to the TRA of 1997 federal change as it relates to personal transactions in foreign currency.

48. <u>Simplify Formation and Operation of International Joint Ventures.</u>

Under **prior federal law**, IRC section 1491 imposed an excise tax on transfers of property by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital or to a foreign partnership, estate or trust. The tax was 35% of the amount of gain inherent in the property transferred but not recognized for income tax purposes at the time of the transfer. However, several exceptions to the excise tax was available. Under IRC section 1494(c), a substantial penalty applied in the case of a failure to report a transfer described in IRC section 1491. Certain transfers were excluded from the excise tax by IRC section 1492.

IRC section 367 applies to require gain recognition upon certain transfers by U.S. persons to foreign corporations. Under IRC section 367(d), a U.S. person that contributes intangible property to a foreign corporation is treated as having sold the property to the corporation and is treated as receiving deemed royalty payments from the corporation. These deemed royalty payments are treated as U.S. source income. A U.S. person may elect to apply similar rules to a transfer of intangible property to a foreign partnership that otherwise would be subject to the IRC section 1491 excise tax.

A foreign partnership may be required to file a partnership return. If a foreign partnership fails to file a required return, losses and credits with respect to the partnership may be disallowed to the partnership. A U.S. person that acquires or disposes of an interest in a foreign partnership, or whose proportional interest in the partnership changes substantially, may be required to file an information return with respect to such event.

The **TRA of 1997** repealed the IRC sections 1491 and 1494 excise tax and information reporting rules that applied to certain transfers of appreciated property by a U.S. person to a foreign entity. Instead of the excise tax that applied under prior law to transfers to a foreign estate or trust, gain recognition is now required upon a transfer of appreciated property by a U.S. person to a foreign estate or trust.

Instead of the excise tax that applied under prior federal law to certain transfers to foreign corporations, regulatory authority is granted under IRC section 367 to deny nonrecognition treatment to such a transfer in a transaction that is not otherwise described in IRC section 367. In the case of a transfer by a U.S. person to a foreign corporation as paid-in surplus or as a contribution to capital in a transaction not otherwise described in IRC section 367 (e.g., a capital contribution by a non-shareholder), regulatory authority is granted under IRC section 367 to treat such transfer as a sale at fair market value and to require gain recognition thereon.

Instead of the excise tax that applies under prior federal law to transfers to foreign partnerships, regulatory authority is granted to provide for gain recognition on a transfer of appreciated property to a partnership in cases where such gain otherwise would be transferred to a foreign partner. In addition, regulatory authority is granted to deny the nonrecognition treatment that is provided under IRC section 1035 to certain exchanges of insurance policies, where the transfer is to a foreign person.

Gain recognition is required upon a transfer of appreciated property by a U.S. person to a foreign estate or trust, except as provided in regulations. This rule does not apply to a transfer to a trust to the extent that any person is treated as the owner of the trust under IRC section 679.

The **TRA of 1997** clarified that, for purposes of the requirement of gain recognition upon a transfer of appreciated property by a U.S. person to a foreign estate or trust, a U.S. trust that becomes a foreign trust is treated as having transferred all of its assets to a foreign trust.

The **TRA of 1997** repealed the rule that treats as U.S. source income any deemed royalty arising under IRC section 367(d). Under the TRA of 1997, in the case of a transfer of intangible property to a foreign corporation, the deemed royalty payments under IRC section 367(d) are treated as foreign source income to the same extent that an actual royalty payment would be considered to be foreign source income. Regulatory authority is granted to provide similar treatment in the case of a transfer of intangible property to a foreign partnership.

The **TRA of 1997** also provides detailed information reporting rules in the case of foreign partnerships. A foreign partnership generally is required to file a partnership return for a taxable year if the partnership has U.S. source income or is engaged in a U.S. trade or business, except to the extent provided in regulations. Failure to properly file a return will result in partners being denied their share of partnership deductions, losses, and credits.

Under the **TRA of 1997**, reporting rules similar to those applicable under present law in the case of controlled foreign corporations apply in the case of foreign partnerships. A U.S. partner that controls a foreign partnership is required to file an annual information return with respect to such partnership. For this purpose, a U.S. partner is considered to control a foreign partnership if the partner holds a more than 50% interest in the capital, profits, or, to the extent provided in regulations, losses, of the partnership.

Similar information reporting also will be required from a U.S. 10% partner of a foreign partnership that is controlled by U.S. 10% partners. A $10,000 penalty applies to a failure to comply with these reporting requirements; additional penalties of up to $50,000 apply in the case of continued noncompliance after notification by the Secretary of the Treasury.

The penalties for failure to report information with respect to a controlled foreign corporation are conformed with these penalties. Under the **TRA of 1997**, reporting by a U.S. person of an acquisition or disposition of an interest in a foreign partnership, or a change in the person’s proportional interest in the partnership, is required only in the case of acquisitions, dispositions, or changes involving at least a 10% interest. A $10,000 penalty applies to a failure to comply with these reporting requirements; additional penalties of up to $50,000 apply in the case of continued noncompliance after notification by the Secretary. The penalties for failure to report information with respect to a foreign corporation are conformed with these penalties.

For purposes of the information reporting rules applicable to a U.S. partner that controls a foreign partnership, the **TRA of 1997** clarifies that a partner’s interest in a partnership is determined with application of constructive ownership rules similar to those provided in IRC section 267(c) (other than paragraph (3)).

Under the **TRA of 1997**, reporting rules similar to those applicable under present law in the case of transfers by U.S. persons to foreign corporations apply in the case of transfers to foreign partnerships. These reporting rules apply in the case of a transfer to a foreign partnership only if the U.S. person holds at least a 10% interest in the partnership or the value of the property transferred by such person to the partnership during a 12-month period exceeded $100,000.

A penalty equal to 10% of the value of the property transferred applies to a failure to comply with these reporting requirements. The penalty under present law for failure to report transfers to a foreign corporation is conformed with this penalty. In the case of a transfer to a foreign partnership, failure to comply also results in gain recognition with respect to the property transferred. The penalty may not exceed $100,000, except in cases of intentional disregard for such reporting requirements.

Under the **TRA of 1997,** in the case of a failure to report required information with respect to a foreign corporation, partnership, or trust, the statute of limitations with respect to any event or period to which such information relates does not expire before the date that is three years after the date on which such information is provided.

California law conforms to IRC section 367, Foreign Corporations, as the IRC read on January 1, 1997, without exception. California is not in conformity with IRC sections 1491 through 1494, Tax on Transfers to Avoid Income Tax.

California law does not generally conform to the federal rules for foreign corporations, except for certain foreign corporations doing business in California that make a water's-edge election. Water's-edge electors are required to use federal rules to determine United States source income, including the rules for foreign corporations. In general, for water's-edge electors, California applies federal rules for transactions with affiliated entities that are not in the water's-edge group. Thus, California generally accepts the federal IRC section 482 allocation for transfers between the water's-edge-group and affiliates (inbound/outbound transfers).

With respect to banks and corporations, other than water's-edge corporations, California uses the world wide combined reporting (WWCR) method of determining the income subject to California tax.

California law does not conform to the excise tax provision in IRC section 1491 or the related reporting requirements and penalty provisions.

California law conforms with certain modifications to the federal requirements to furnish information about foreign-owned corporations and the related penalties (R&TC section 19141.5). In addition, California recently conformed to federal foreign reporting requirements (Form 5471) by adding section 19141.2 to the R&TC (Ch. 611, 1997).

Under **California law** insurance companies are not subject to the California franchise or income tax. However, life insurance companies are subject to the gross premiums tax, which is administered by the Board of Equalization.

This bill would conform California law to the TRA of 1997 federal change as it relates to international joint ventures as discussed above.

49. Increase Standard Deduction and AMT Exemption Amount for Kiddie Tax.

Standard deduction of dependents -- Under **prior federal law**, the standard deduction of a taxpayer for whom a dependency exemption is allowed on another taxpayer's return cannot exceed the lesser of (1) the standard deduction for an individual taxpayer (projected to be $4,250 for 1998) or (2) the greater of $500 (indexed, projected to be $700 for 1998) or the dependent's earned income

Taxation of unearned income of children under age 14 -- The tax on a portion of the unearned income (e.g., interest and dividends) of a child under age 14 is the additional tax that the child's custodial parent would pay if the child's unearned income were included in that parent's income. The portion of the child's unearned income which is taxed at the parent's top marginal rate is the amount by which the child's unearned income is more than the sum of (1) $500 (indexed) plus (2) the greater of (a) $500 (indexed) or (b) the child's itemized deductions directly connected with the production of the unearned income (sec. 1(g)).

Alternative minimum tax (AMT) exemption for children under age 14 -- Single taxpayers are entitled to an exemption from the AMT of $33,750. However, in the case of a child under age 14, his exemption from the AMT, in substance, is the unused AMT exemption of the child's custodial parent, limited to the sum of earned income and $1,000 (indexed, projected to be $1,400 for 1998).

The **TRA of 1997** changed the standard deduction for dependents. The standard deduction of a taxpayer for whom a dependency exemption is allowed on another taxpayer's return cannot exceed the lesser of (1) the standard deduction for individual taxpayers or (2) the greater of: (a) $500 (indexed for inflation from calendar year 1987, which is the same as prior law), or (b) the individual's earned income plus $250 (indexed for inflation after calendar year 1998).

The **TRA of 1997** also changed the AMT exemption for children under age 14. The AMT exemption for a child under age 14 is the lesser of (1) $33,750 or (2) the sum of the child's earned income plus $5,000 (indexed for inflation after calendar year 1998).

With respect to both of the above provisions, **California law** conforms to federal law prior to the TRA of 97, including the federal inflation adjustment:

- The standard deduction of a taxpayer for whom a dependency exemption is allowed on another taxpayer's return cannot exceed the lesser of (1) the standard deduction for individual taxpayers or (2) the greater of: (a) $500 (indexed for inflation from calendar year 1987), or (b) the individual's earned income.

- The AMT exemption for children under age 14 is the unused AMT exemption of the child's custodial parent, limited to the sum of earned income and $1,000 (indexed for inflation.)

This bill would conform California law to the TRA of 1997 federal change as it relates to AMT exemption amount for kiddie tax, but not to the increase in the standard deduction (since California uses exemption credits instead of a standard deduction).

50. Increase Amount of Tax Exempt from Estimated Tax Requirements.

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax. An individual generally does not have an underpayment of estimated tax if he or she makes certain timely estimated tax payments based on the tax shown on the return for the preceding or the current year. Income tax withholding from wages is considered to be a payment of estimated taxes.

Under federal law, as amended by **the TRA of 1997**, the addition to tax is not imposed where the total tax liability for the year, reduced by any withheld tax, is less than $1,000, rather than the pre-TRA of 97 amount of $500.

California law requires estimated tax payments and imposes an addition to tax for certain underpayments of estimated tax by individual taxpayers comparable to the federal law relating to estimated tax payments. However, the amount that constitutes an underpayment for California differs from the federal law. Additionally, the circumstances under which an addition to tax would not be imposed for an underpayment of estimated tax differ. For California purposes, the addition to tax is not imposed for individual taxpayers, generally, where withholding is equal to 80% of the tax liability or the tax liability for the year reduced by all credits (estimated tax and withholding credits) is $100 or less ($50 for married persons filing separate returns).

This bill, in its present form**,** would increase the tax exempt from estimated tax requirements for state purposes from $100 to $1,000 ($50 to $500 for married filing separate taxpayers). The author’s office has advised the department that increasing the exempt amount by 10 fold was a drafting error. It was intended to double the state’s exempt tax amount as was done by the TRA of 1997 for federal purposes. (Please see amendments 1 and 2 to accomplish this correction.) The revenue estimate included in this analysis is based on “as to be amended” tax exempt figures of $200 and $100. If the bill is not amended, the revenue estimate for this item will be significantly higher.

51. Treatment of Certain Reimbursed Expenses of Rural Mail Carriers.

The **TRA of 1997** provides that for employees using their automobile in performing services involving the collection and delivery of mail on a rural route and reimbursed by the U.S. Postal Service at a rate contained in their 1991 collective bargaining agreement, their business expense deduction is equal to the reimbursement, which may be increased by no more than the rate of inflation. Under this treatment, income and expenses would be equal, so that neither will have to be reported on the taxpayer’s tax return.

California law conforms to the federal law prior to amendments by the TRA of 97 as it conforms to the underlying federal law relating to itemized deductions and adjusted gross income for individuals. Postal Service employees who are paid an equipment maintenance allowance (EMA) for using their automobile for the collection and delivery of mail on a rural route may compute their deduction for business by using, for all business-use mileage, 150% of the standard mileage rate for the first 15,000 miles of business use of an automobile that is not fully depreciated. Using this method, the tax is determined by comparing the EMA to the automobile expense deductions that each carrier is allowed to claim (using either the actual expenses method or the 150% of the standard mileage rate). If the EMA exceeds the allowable automobile expense deductions, the excess generally is subject to tax. If the EMA falls short of the allowable automobile expense deductions, a deduction is allowed, but only to the extent that the sum of this shortfall and all other miscellaneous itemized deductions exceeds 2% of the taxpayer's adjusted gross income.

This bill would conform California law to the TRA of 1997 federal change as it relates to rural mail carriers' EMA.

52. Travel Expenses for Certain Federal Employees.

The **TRA of 1997** provides that the one-year limitation with respect to deductibility of an employee's expenses while temporarily away from home does not include any period during which a federal employee is certified by the Attorney General (or the Attorney General's designee) as traveling on behalf of the federal government in a temporary duty status to investigate or provide support services to the investigation of a federal crime. Therefore, expenses for these individuals during these periods are deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied).

California law conforms to the federal law prior to the TRA of 97 amendments as it conforms to the underlying law relating to itemized deductions for individuals. Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs and the cost of meals and lodging) are generally deductible, subject to the 2% floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible. A taxpayer's employment away from home in a single location is indefinite rather than temporary if it lasts for one year or more; thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment. If a taxpayer's employment away from home in a single location lasts for less than one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances.

This bill would conform California law to the TRA of 1997 federal change as it relates to travel expenses for certain federal employees.

53. Modifications to Look-Back Method for Long-Term Contracts.

Under **federal law**, taxpayers engaged in the production of property under a long-term contract generally compute income from the contract under the percentage of completion method. Under this method, the taxpayer includes in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with estimated total contract costs. Because the percentage of completion method relies upon the estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back" method is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. For the second step, the taxpayer recomputes the tax liability for each year of the contract using gross income as reallocated under the “look-back” method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, the difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily. The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments. The overpayment rate equals the applicable Federal short-term rate plus two percentage points. This rate is adjusted quarterly by the IRS, therefore, in applying the “look-back” method for a contract year, a taxpayer may be required to use five different interest rates.

Under the **TRA of 1997**, a taxpayer may elect not to apply the “look-back” method with respect to a long-term contract, if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10% of the cumulative taxable income (or loss) as determined using actual contract price and costs.

Additionally, under the **TRA of 1997**, a taxpayer may elect not to reapply the “look-back” method with respect to costs incurred after completion of the long-term contract, if as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10% of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above). For purposes of the “look-back” method, the applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins, which is the day after the return due date (determined without regard to extensions) for the taxable year, and ends on such return due date for the following taxable year.

California law conforms to the federal “look-back” method without the alternative treatment allowed by TRA of 1997.

This bill would conform California law to the TRA of 1997 federal change as it relates to modification of the look-back method for long-term contracts.

54. <u>Treatment of Construction Allowance Provided to Lessee.</u>

Issues have arisen as to the proper treatment of amounts provided to a lessee by a lessor for property to be constructed and used by the lessee pursuant to the lease (“construction allowances”). In general, incentive payments are includible in income as accessions to wealth. A coordinated issue paper issued by the Internal Revenue Service (IRS) on October 7, 1996, states the IRS position that construction allowances should generally be included in income in the year received. However, the paper does recognize that amounts received by a lessee from a lessor and expended by the lessee on assets owned by the lessor were not includible in the lessee's income. The issue paper provides that tax ownership is determined by applying a “benefits and burdens of ownership” test that includes an examination of several factors.

The **TRA of 1997** codified the treatment recognized in the federal coordinated issue paper. Additionally, however, it provides a safe harbor by providing that (1) a lessee’s gross income would not include amounts received in cash (or treated as a rent reduction) from a lessor under a short-term lease of retail space for the purpose of the lessee's construction or improvement of qualified long-term real property for use in the lessee's trade or business at such retail space; and (2) the lessor must treat the amounts expended on the construction allowance as nonresidential real property owned by the lessor for depreciation.

The exclusion only applies to the extent the allowance does not exceed the amount expended by the lessee on the construction or improvement of qualified long-term real property. Reporting requirements are provided to ensure that both the lessor and lessee treat such amounts in accordance with the provision. Under regulations, the lessor and the lessee shall, at such times and in such manner as provided by the regulations, furnish to the Secretary of the Treasury information concerning the amounts received (or treated as a rent reduction), the amounts expended on qualified long-term real property, and such other information as the Secretary deems necessary to carry out the provision.

California law conforms to the federal treatment described in the federal issue paper by virtue of conforming to the underlying federal law relating to items specifically excluded from gross income.

This bill would conform California law to the TRA of 1997 federal change as it relates to construction allowance provided to lessees.

55. Closing of Partnership Year with Respect to Deceased Partner.

Under **federal law**, the partnership taxable year closes with respect to a partner whose entire interest is sold, exchanged, or liquidated. Prior to the passage of the **TRA of 1997**, such year generally did not close upon the death of a partner. Thus, under prior law, a decedent's entire share of items of income, gain, loss, deduction and credit for the partnership year in which death occurs was taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return.

The **TRA of 1997** provided that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise. The provision does not change the law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy).

California law conforms to federal law as it read on January 1, 1997, which did not provide for the close of the partnership taxable year due to the death of a partner as it relates to the decedent.

This bill would conform California law to the TRA of 1997 federal change as it relates to the closing of the partnership year with respect to a deceased partner.

56. Provide Additional Exceptions for Reasonable Cause for Penalties.

Under **federal and state law**, many penalties in the IRC may be waived if the taxpayer establishes reasonable cause. For example, the accuracy-related penalty may be waived with respect to any item if the taxpayer establishes reasonable cause for his treatment of the item and that he acted in good faith.

Under the **TRA of 1997**, the following penalties may be waived if the failure is shown to be due to reasonable cause and not willful neglect:
(1) the penalty for failure to make a report in connection with deductible employee contributions to a retirement savings plan (sec. 6652(g));
(2) the penalty for failure to make a report as to certain small business stock (sec. 6652(k));
(3) the penalty for failure of a foreign corporation to file a return of personal holding company tax (sec. 6683); and
(4) the penalty for failure to make required payments for S corporations and partnerships electing not to have the required taxable year (sec. 7519).

Under **California law**, many penalty laws administered by FTB are comparable to those administered by IRS, and many allow for a waiver of the penalty if the taxpayer can establish that the failure to comply was based on reasonable cause. Of the four penalties amended by the TRA of 1997 to provide for waiver of penalty based on reasonable cause, FTB administers only one comparable penalty, which is the failure to make a report as to certain small business stock. For this penalty, California conforms to the federal law prior to the TRA of 1997; therefore, the penalty cannot be waived based on reasonable cause. For the other three penalties, California does not have comparable provisions because California relies on the IRS/FTB exchange of information system and IRS penalty to encourage compliance (employee contributions to retirement plans and S corporations elections) or does not have a comparable underlying provision (foreign personal holding companies).

This bill would conform California law to the TRA of 1997 federal change by allowing a reasonable cause exception for the failure to report certain small business stock penalties.

57. Clarification of Statute of Limitations for Pass-Through Entity Items.

Under **federal law**, pass-through entities (such as S corporations, partnerships, and certain trusts) generally are not subject to income tax on their taxable income. Instead, these entities file information returns and the entities' shareholders (or beneficial owners) report their pro rata share of the gross income and are liable for any taxes due. Some believe that, prior to 1993, it may have been unclear as to whether the statute of limitations (SOL) for adjustments that arise from pass-through distributive items from these pass-through entities should be applied at the entity or individual level (i.e., whether the three-year federal statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). In 1993, the Supreme Court held that the limitations period for assessing the income tax liability of an S corporation shareholder runs from the date the shareholder's return is filed (Bufferd v. Commissioner., 113 S. Ct. 927 (1993)).

The **TRA of 1997** clarified that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.

Under **California law**, the SOL for partnership items reported on the partner's tax return are treated two different ways, depending on the type of partnership. Generally, the SOL for a partnership item passed-through from a "federally registered partnership" is five years from the date the PARTNERSHIP return is filed. A federally registered partnership is a partnership required to register certain type of partnership offerings or annual reports with the Securities and Exchange Commission (SEC). A federally registered partnership generally will have more than 34 limited partners (or have a public offering to purchase a partnership interest to more than 34 potential limited partners).

The SOL for partnership items of non-federally registered partnership is the SOL for the PARTNER's return (normally four years after the date of filing).

As to the federal provision relating to S corporations, **California law** treats both the S corporation and shareholder as taxpayers and California conceptually conforms to federal law. The return due date that starts the running of the SOL for a shareholder is the return of the shareholder and not the return of the S corporation from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.

This bill would clarify that the SOL for assessing tax is four years from the date a return is filed by the "taxpayer" and does not include a return from a "person" from whom the taxpayer has received any pass-through item from. This bill would not change the treatment of items passed-through from a federally registered partnership.

58. <u>Items Relating to Income Taxation of Estates.</u>

Background of **Federal Law**.

Both estates and revocable inter vivos trusts can function to settle the affairs of a decedent and distribute assets to heirs. In the case of revocable inter vivos trusts, the grantor transfers property into a trust which is revocable during his or her lifetime. Upon the grantor's death, the power to revoke ceases and the trustee then performs the settlement functions typically performed by the executor of an estate. While both estates and revocable trusts perform essentially the same function after the testator or grantor's death, there are a number of ways in which an estate and a revocable trust operate differently. First, there can be only one estate per decedent while there can be more than one revocable trust. Second, estates are in existence only for a reasonable period of administration; revocable trusts can perform the same settlement functions as an estate, but may continue in existence thereafter as testamentary trusts. Numerous differences presently exist between the income tax treatment of estates and revocable trusts, including: (1) estates are allowed a charitable deduction for amounts permanently set aside for charitable purposes while post-death revocable trusts are allowed a charitable deduction only for amounts paid to charities; (2) the active participation requirement contained in the passive loss rules under IRC section 469 is waived in the case of estates (but not revocable trusts) for two years after the owner's death; and (3) estates (but not revocable trusts) can qualify for IRC section 194 amortization of reforestation expenditures.

In general, trusts and estates are treated as conduits for federal income tax purposes. Income received by a trust or estate which is distributed to a beneficiary in the trust or estate's taxable year "ending with or within" the taxable year of the beneficiary is taxable to the beneficiary in that year; income that is retained by the trust or estate is initially taxable to the trust or estate. In the case of distributions of previously accumulated income by trusts (but not estates), there may be additional tax under the so-called "throwback" rules if the beneficiary to whom the distributions were made has marginal rates higher than those of the trust. Under the "65-day rule," a trust may elect to treat distributions paid within 65 days after the close of its taxable year as paid on the last day of its taxable year. The 65-day rule is not applicable to estates.

Trusts with more than one beneficiary must use the "separate share" rule in order to provide different tax treatment of distributions to different beneficiaries to reflect the income earned by different shares of the trust's corpus. Treasury regulations provide that the application of the separate share rule will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Separate share treatment will not be applied to a trust or portion of a trust subject to a power to distribute, apportion, or accumulate income or distribute corpus to or for the use of one or more beneficiaries within a group or class of beneficiaries, unless the payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made under the governing instrument so that substantially separate and independent shares exist. The separate share rule presently does not apply to estates. Application of the separate share rule is not elective; it is mandatory if there are separate shares in the trust.

IRC section 267 disallows a deduction for any loss on the sale of an asset to a person related to the taxpayer. For purposes of IRC section 267, the following parties are treated as related persons: (1) a trust and the trust's grantor, (2) two trusts with the same grantor, (3) a trust and a beneficiary of the trust, (4) a trust and a beneficiary of another trust, if both trusts have the same grantor, and (5) a trust and a corporation the stock of which is more than 50% owned by the trust or the trust's grantor. IRC section 1239 disallows capital gain treatment on the sale of depreciable property to a related person. For purposes of IRC section 1239, a trust and any beneficiary of the trust are treated as related persons, unless the beneficiary's interest is a remote contingent interest. Neither IRC section 267 nor IRC section 1239 presently treat an estate and a beneficiary of the estate as related persons.

TRA of 1997 Changes to Federal Law.

Certain Revocable Trusts as Part of Estate - The **TRA of 1997** provided an irrevocable election to treat a qualified revocable trust as part of the decedent's estate for federal income tax purposes. This elective treatment is effective from the date of the decedent's death until two years after his or her death (if no estate tax return is required) or, if later, six months after the final determination of estate tax liability (if an estate tax return is required). The election must be made by both the executor of the decedent's estate (if any) and the trustee of the revocable trust no later than the time required for filing the income tax return of the estate for its first taxable year, taking into account any extensions. A conforming change is made to IRC section 2652(b) for generation-skipping transfer tax purposes. For this purpose, a qualified revocable trust is any trust (or portion thereof) which was treated under IRC section 676 as owned by the decedent with respect to whom the election is being made, by reason of a power in the grantor (i.e., trusts that are treated as owned by the decedent solely by reason of a power in a nonadverse party would not qualify). The separate share rule (described above) generally will apply when a qualified revocable trust is treated as part of the decedent's estate.

Distributions During First 65 Days of Taxable Year of Estate - The **TRA of 1997** extends application of the 65-day rule to distributions by estates. Thus, an executor can elect to treat distributions paid by the estate within 65 days after the close of the estate's taxable year as having been paid on the last day of such taxable year.

Separate Share Rules Available To Estate - The **TRA of 1997** extends the application of the separate share rule to estates. There are separate shares in an estate when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specified items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries. For example, a separate share in an estate would exist where the decedent's will provides that all shares of a closely-held corporation are devised to one beneficiary and that any dividends paid to the estate by that corporation should be paid only to that beneficiary and any such dividends would not affect any other amounts which that beneficiary would receive under the will. As in the case of trusts, the application of the separate share rule is mandatory where separate shares exist.

Executor of Estate and Beneficiaries Treated as Related Persons for Disallowance of Losses -Under the **TRA of 1997**, an estate and a beneficiary of that estate are treated as related persons for purposes of IRC sections 267 and 1239, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

California law conforms to federal income tax law relating to estates, trusts, beneficiaries, and decedents as it read January 1, 1997. California law has additional rules relating to the apportionment of taxable income of estates and trusts based on the respective residence of the fiduciaries and beneficiaries. California law does not contain a gift tax and the estate tax is a "pick-up" tax, that is, the state tax is equal to the maximum credit for a state tax on the federal estate tax return for that particular decedent's estate. This "pick-up" tax is administered by the State Controller's Office.

This bill would conform California law to the TRA of 1997 federal change as it relates to the income taxation of the income of estates and trusts.

59. Certain Notices Disregarded Under Provision Increasing Interest Rate on Large Corporate Underpayments.

Under **federal law,** the interest rate on a large corporate underpayment of tax is the federal short-term rate plus five percentage points. A large corporate underpayment is any underpayment by a subchapter C corporation of any tax imposed for any taxable period, if the amount of such underpayment for such period exceeds $100,000. Under **prior federal law**, the large corporate underpayment rate generally applied to periods beginning 30 days after the earlier of the date on which the first letter of proposed deficiency, a statutory notice of deficiency, or a nondeficiency letter or notice of assessment or proposed assessment is sent. For this purpose, a letter or notice is disregarded if the taxpayer makes a payment equal to the amount shown on the letter or notice within that 30 day period.

Under the **TRA of 1997,** for purposes of determining the period to which the large corporate underpayment rate applies, any letter or notice is disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than $100,000 (determined by not taking into account any interest, penalties, or additions to tax).

Except for the inherent difference in the definition of deficiency, **California law** is in conformity with federal law as it read on January 1, 1997, as it relates to an increased interest rate for underpayments of large corporations.

This bill would conform California law to the TRA of 1997 federal change as it relates to increasing the interest rate on large corporate underpayments.

60. Pension Simplification Provisions.

TRA of 1997 Changes to Federal Law.

Matching Contributions of Self-Employed Individuals Not Treated as Elective Deferrals - Under present and prior law, a qualified cash or deferred arrangement (a “IRC section 401(k) plan”) is a type of tax-qualified pension plan under which employees can elect to make pre-tax deferrals. An employee's annual elective deferrals are subject to a dollar limit ($10,000 for 1998). Employers may make matching contributions based on employees' elective deferrals. In the case of employees, such matching contributions are not subject to the $10,000 limit on elective deferrals. Elective deferrals are subject to a special nondiscrimination test, called the average deferral percentage (ADP) test. Under the ADP test, the maximum amount of elective deferrals that can be made by highly compensated employees is based on the amount of elective deferrals made by nonhighly compensated employees. Matching contributions are subject to a similar nondiscrimination test, called the average contribution percentage (ACP) test. An employer may treat certain qualified matching contributions as elective deferrals for purposes of satisfying the ADP test.

Under present and prior law, a SIMPLE retirement plan is either an individual retirement arrangement (IRA) or part of a 401(k) plan that meets certain requirements. Under a SIMPLE retirement plan, employees can elect to make pre-tax deferrals of up to $6,000 per year. Employers are required to make either a matching contribution of up to 3% of the employee's compensation or, alternatively, the employer can elect to make a lower percentage contribution on behalf of all eligible employees. Contributions to a SIMPLE retirement plan are not subject to the ADP or ACP tests.

Under **prior federal law**, matching contributions made for a self-employed individual were generally treated as additional elective deferrals by the self-employed individual who received the matching contribution. Accordingly, elective deferrals and matching contributions for self-employed individuals were subject to the dollar limits on elective deferrals and, in the case of a 401(k) plan, treated as elective deferrals for purposes of the ADP test.

The **TRA of 1997** provides that matching contributions for self-employed individuals are treated the same as matching contributions for employees, i.e., they are not subject to the elective deferral limits and are not treated as elective deferrals for purposes of the ADP test (unless the employer elects to treat qualified matching contributions as elective deferrals under the ADP test). The provision does not apply to qualified matching contributions that are treated as elective deferrals for purposes of satisfying the ADP test.

Modification of Prohibition on Assignment or Alienation - Under present and prior law, amounts held in a qualified retirement plan for the benefit of a participant are not, except in very limited circumstances, assignable or available to personal creditors of the participant. A plan may permit a participant, at such time as benefits under the plan are in pay status, to make a voluntary revocable assignment of an amount not in excess of 10% of any benefit payment, provided the purpose is not to defray plan administration costs. In addition, a plan may comply with a qualified domestic relations order issued by a state court requiring benefit payments to former spouses or other “alternate payees” even if the participant is not in pay status.

Under **prior federal law**, no specific exception under the Employee Retirement Income Security Act of 1974, as amended (ERISA), or the IRC would permit the offset of a participant's benefit against the amount owed to a plan by the participant as a result of a breach of fiduciary duty to the plan or criminality involving the plan. Courts were divided in their interpretation of the prohibition on assignment or alienation in these cases. Some courts ruled that there is no exception in ERISA for the offset of a participant's benefit to make a plan whole in the case of a fiduciary breach. Other courts reached a different result and permitted an offset of a participant's benefit for breach of fiduciary duties.

The **TRA of 1997** permits a participant's benefit in a qualified plan to be reduced to satisfy liabilities of the participant to the plan due to (1) the participant being convicted of committing a crime involving the plan, (2) a civil judgment (or consent order or decree) entered by a court in an action brought in connection with a violation of the fiduciary provisions of ERISA, or (3) a settlement agreement between the Secretary of Labor or the Pension Benefit Guaranty Corporation and the participant in connection with a violation of the fiduciary provisions of ERISA. The court order establishing such liability must require that the participant's benefit in the plan be applied to satisfy the liability. If the participant is married at the time his or her benefit under the plan is offset to satisfy the liability, spousal consent to such offset is required unless the spouse is also required to pay an amount to the plan in the judgment, order, decree or settlement or the judgment, order, decree or settlement provides a 50% survivor annuity for the spouse. An offset is includible in income on the date of the offset (except to the extent attributable to the employee's basis).

Permanent Moratorium on Application of Nondiscrimination Rules to State and Local Governmental Plans - Under prior federal law, the rules applicable to governmental plans require that such plans satisfy certain nondiscrimination and minimum participation rules. In general, the rules require that a plan not discriminate in favor of highly compensated employees with regard to the contribution and benefits provided under the plan, participation in the plan, coverage under the plan, and compensation taken into account under the plan. The nondiscrimination rules apply to all governmental plans, qualified retirement plans (including cash or deferred arrangements (sec. 401(k) plans) in effect before May 6, 1986) and annuity plans (sec. 403(b) plans). Elective deferrals under IRC section 401(k) plans are required to satisfy the ADP test. Employer matching and after-tax employee contributions are subject to the ACP test.

For purposes of satisfying the nondiscrimination rules, the IRS has issued several notices which extended the effective date for compliance for governmental plans. Under these notices, governmental plans would be required to comply with the nondiscrimination rules beginning with plan years beginning on or after the later of January 1, 1999, or 90 days after the opening of the first legislative session beginning on or after January 1, 1999, of the governing body with authority to amend the plan, if that body does not meet continuously. For plan years beginning before the extended effective date, governmental plans are deemed to satisfy the nondiscrimination requirements.

The **TRA of 1997** provides that state and local governmental plans are permanently exempt from the nondiscrimination and minimum participation rules. The exemption from the nondiscrimination and participation rules includes exemption from the ADP and ACP tests. A cash or deferred arrangement under a governmental plan is treated as a qualified cash or deferred arrangement even though the ADP test is not in fact satisfied. Thus, for example, elective contributions made by a governmental employer on behalf of an employee are not treated as distributed or made available to the employee (in accordance with IRC section 402(e)(3)).

Clarification of Certain Rules Relating to ESOPs of S Corporations - Under **present and prior law**, an S corporation can have no more than 75 shareholders. For taxable years beginning after December 31, 1997, certain tax-exempt organizations, including employee stock ownership plans (ESOPs), can be a shareholder of an S corporation.

ESOPs are generally required to make distributions in the form of employer securities. If the employer securities are not readily tradable, the employee has a right to require the employer to buy the securities. In the case of an employer whose bylaws or charter restricts ownership of substantially all employer securities to employees or a pension plan, the plan may provide that benefits are distributed in the form of cash. Such a plan may distribute employer securities, if the employee has a right to require the employer to purchase the securities. Under prior law, similar rules did not apply in the case of an ESOP maintained by an S corporation.

ESOPs are subject to certain prohibited transaction rules under the IRC and Title I of ERISA which are designed to prohibit certain transactions between the plan and certain persons close to the plan. A number of statutory exceptions are provided to the prohibited transaction rules. Under prior law, these statutory exceptions did not apply to any transaction in which a plan (directly or indirectly) (1) lends any part of the assets of the plan to, (2) pays any compensation for personal services rendered to the plan to, or (3) acquires for the plan any property from or sells any property to a shareholder employee of an S corporation, a member of the family of such a shareholder employee, or a corporation controlled by the shareholder employee. An administrative exception from the prohibited transactions rules may be obtained from the Secretary of Labor, even if a statutory exception does not apply.

The **TRA of 1997** provides that ESOPs of S corporations may distribute cash to plan participants. Such a plan may distribute employer securities as long as the employee has a right to require the employer to purchase the securities (as under the rules applicable to ESOPs generally). In addition, the TRA of 1997 provides that the statutory exceptions to the prohibited transaction rules do not fail to apply merely because a transaction involves the sale of employer securities to an ESOP maintained by an S corporation by a shareholder employee, a family member of the shareholder employee, or a corporation controlled by the shareholder employee. Thus, the statutory exemptions for such a transaction (including the exemption for a loan to the ESOP to acquire employer securities in connection with such a sale or a guarantee of such a loan) apply. The provision is effective for taxable years beginning after December 31, 1997.

Modify Funding Requirements for Certain Plans - Under **present and prior law**, defined benefit pension plans are required to meet certain minimum funding rules. Underfunded plans are required to satisfy certain faster funding requirements. In general, these additional requirements do not apply in the case of plans with a funded current liability percentage of at least 90%.

The Pension Benefit Guaranty Corporation (PBGC) insures benefits under most defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and a variable rate premium based on plan underfunding.

The **TRA of 1997** modifies the minimum funding requirements in the case of certain plans. The TRA of 1997 applies in the case of plans that (1) were not required to pay a variable rate PBGC premium for the plan year beginning in 1996, (2) do not, in plan years beginning after 1995 and before 2009, merge with another plan (other than a plan sponsored by an employer that was a member of the controlled group of the employer in 1996), and (3) are sponsored by a company that is engaged primarily in the interurban or interstate passenger bus service.

The **TRA of 1997** treats a plan to which it applies as having a funded current liability percentage of at least 90% for plan years beginning after 1996 and before 2005. For plan years beginning after 2004, the funded current liability percentage will be deemed to be at least 90% if the actual funded current liability percentage is at least at certain specified levels.

The relief from the minimum funding requirements applies for plan years beginning in 2005, 2006, 2007, and 2008 only if contributions to the plan equal at least the expected increase in current liability due to benefits accruing during the plan year.

Plans Not Disqualified Merely by Accepting Rollover Contributions - Under **present and prior law**, Treasury regulations provide that a qualified retirement plan that accepts rollover contributions from other plans will not be disqualified because the plan making the distribution is, in fact, not qualified at the time of the distribution if, prior to accepting the rollover, the receiving plan reasonably concluded that the distributing plan was qualified. The receiving plan can reasonably conclude that the distributing plan was qualified if, for example, prior to accepting the rollover, the distributing plan provided a statement that the distributing plan had a favorable determination letter issued by the Internal Revenue Service. The receiving plan is not required to verify this information.

The **TRA of 1997** directs the Secretary of the Treasury to clarify that, under its regulations protecting plans from disqualification because they receive invalid rollover contributions, it is not necessary for a distributing plan to have a determination letter in order for the administrator of the receiving plan to reasonably conclude that a contribution is a valid rollover.

Except for tax rates and the imposition of excise taxes, **California law** is in full conformity to the various pension provisions as of January 1, 1997. California law does not have a separate program dedicated to monitoring and enforcing pension plan rules. By being fully conformed to the federal provisions, California benefits from the federal government's monitoring and enforcement of pension plans.

This bill would conform California law to the TRA of 1997 federal change as it relates to various pension provisions described above.

61. <u>Miscellaneous Provisions Relating to Pensions and Other Benefits.</u>

TRA of 1997 Changes to Federal Law.

Increase in Full Funding Limit - Under **present and prior law**, defined benefit pension plans are subject to minimum funding requirements. In addition, there is a maximum limit on contributions that can be made to a plan, called the full funding limit. Under **prior federal law**, the full funding limit was generally the lesser of a plan's accrued liability and 150% of current liability. In general, current liability includes all liabilities to plan participants and beneficiaries. Current liability represents benefits accrued to date, whereas the accrued liability full funding limit is based on projected benefits. Under IRS rules, amounts that cannot be contributed because of the current liability full funding limit are amortized over 10 years.

The **TRA of 1997** increases the 150% of current liability full funding limit as follows: 155% for plan years beginning in 1999 or 2000, 160% for plan years beginning in 2001 or 2002, 165% for plan years beginning in 2003 and 2004, and 170% for plan years beginning in 2005 and thereafter. In addition, amounts that cannot be contributed due to the current liability full funding limit are amortized over 20 years. Amounts that could not be contributed because of the prior-law current liability full funding limit and that have not been amortized as of the last day of the last plan year beginning in 1998 are amortized over this 20-year period. With respect to amortization bases remaining at the end of the 1998 plan year, the 20-year amortization period is reduced by the number of years since the amortization base had been established. No amortization is required with respect to funding methods that do not provide for amortization bases.

Contributions on Behalf of a Minister to a Church Plan - Under **present and prior law**, contributions made to retirement plans by ministers who are self-employed are deductible to the extent such contributions do not exceed certain limitations applicable to retirement plans. These limitations include the limit on elective deferrals, the exclusion allowance, and the limit on annual additions to a retirement plan.

The **TRA of 1997** provides that in the case of a contribution made to a church plan on behalf of a minister who is self-employed, the contribution is excludable from the income of the minister to the extent that the contribution would be excludable if the minister were an employee of a church. The provision does not alter present law under which amounts contributed for a minister in connection with IRC section 403(b), either by the minister's actual employer or by any church or convention or association of churches that is treated as the minister's employer under IRC section 414(e), are excluded from the minister's income, and amounts contributed in accordance with IRC section 403(b) by the minister (whether the minister is an employee or is self-employed) are deductible by the minister as provided in IRC section 404 taking into account the other special rules of IRC section 414(e). A minister will not be entitled to both an exclusion and deduction for the same contribution.

Exclusion of Ministers from Discrimination Testing of Certain Non-Church Retirement Plans - Under **present and prior law** ministers who are employed by an organization other than a church are treated as if employed by the church and may participate in the retirement plan sponsored by the church. Under **prior law**, if the organization also sponsored a retirement plan, such plan did not have to include the ministers as employees for purposes of satisfying the nondiscrimination rules applicable to qualified plans provided the organization was not eligible to participate in the church plan.

The **TRA of 1997** provides that if a minister is employed by an organization other than a church and the organization is not otherwise participating in the church plan, then the minister does not have to be included as an employee under the retirement plan of the organization for purposes of the nondiscrimination rules. The provision is effective for years beginning after December 31, 1997.

Repeal Application of UBIT to ESOPs of S Corporations - Under present and prior law, for taxable years beginning after December 31, 1997, certain tax-exempt organizations, including ESOPs, can be a shareholder of an S corporation. Under prior law, items of income or loss of the S corporation flowed through to all qualified tax-exempt shareholders as unrelated business taxable income (UBI), regardless of the source of the income.

The **TRA of 1997** repeals the provision treating items of income or loss of an S corporation as unrelated business taxable income in the case of an employee stock ownership plan that is an S corporation shareholder. The repeal of such provision applies only with respect to employer securities held by an employee stock ownership plan (as defined in IRC section 4975(e)(7)) maintained by an S corporation.

Cash or Deferred Arrangements for Irrigation and Drainage Entities - Under **present and prior law**, taxable and tax-exempt employers may maintain qualified cash or deferred arrangements. Under **prior law**, all state and local government organizations generally were prohibited from maintaining qualified cash or deferred arrangements ("IRC section 401(k) plans"), other than qualified cash or deferred arrangements adopted by a state or local government before May 6, 1986.

Mutual irrigation or ditch companies are exempt from tax if at least 85% of the income of the company consists of amounts collected from members for the sole purpose of meeting losses and expenses.

Under the **TRA of 1997**, mutual irrigation or ditch companies and districts organized under the laws of a state as a municipal corporation for the purpose of irrigation, water conservation or drainage (or a national association of such organizations) are permitted to maintain qualified cash or deferred arrangements, even if the company or district is a state or local governmental organization.

Portability of Permissive Service Credit under Governmental Pension Plans - Under present and prior law, limits are imposed on contributions and benefits under qualified pension plans. In the case of a defined contribution plan, the limit on annual additions is the lesser of $30,000 or 25% of compensation. Annual additions include employer contributions, as well as after-tax employee contributions. In the case of a defined benefit pension plan, the limit on the annual retirement benefit is the lesser of (1) 100% of compensation or (2) $120,000 (indexed for inflation). The 100% of compensation limitation does not apply in the case of state and local governmental pension plans. Certain other special rules apply in the case of state and local governmental plans.

Amounts contributed by employees to a state or local governmental plan are treated as made by the employer if the employer "picks up" the contribution.

Under **prior law,** no special rules applied to make-up contributions by state and local government employees.

Under the **TRA of 1997**, contributions by a participant in a state or local governmental plan to purchase permissive service credits are subject to one of two limits. Either (1) the accrued benefit derived from all contributions to purchase permissive service credit must be taken into account in determining whether the defined benefit pension plan limit is satisfied, or (2) all such contributions must be taken into account in determining whether the $30,000 limit on annual additions is met for the year (taking into account any other annual additions of the participant). Under the first alternative, a plan will not fail to satisfy the reduced defined benefit pension plan limit that applies in the case of early retirement due to the accrued benefit derived from the purchase of permissive service credits. These limits may be applied on a participant-by-participant basis. That is, contributions to purchase permissive service credits by all participants in the same plan do not have to satisfy the same limit.

Under the **TRA of 1997**, permissive service credit means credit for a period of service recognized by the governmental plan only if the employee voluntarily contributes to the plan an amount (as determined by the plan) which does not exceed the amount necessary to fund the benefit attributable to the period of service and which is in addition to the regular employee contributions, if any, under the plan. IRC section 415 is violated if more than 5 years of permissive service credit is purchased for "nonqualified service." In addition, IRC section 415 is violated if nonqualified service is taken into account for an employee who has less than five years of participation under the plan. Nonqualified service is service other than service (1) as a Federal, state, or local government employee, (2) as an employee of an association representing federal, state or local government employees, (3) as an employee of an educational institution which provides elementary or secondary education, or (4) for military service. Service under (1), (2) or (3) is not qualified if it enables a participant to receive a retirement benefit for the same service under more than one plan.

The **TRA of 1997** provides that in the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a state or local government employer within the same state), any such repayment shall not be taken into account for purposes of IRC section 415 and service credit obtained as a result of the repayment shall not be considered permissive service credit.

The provision is not intended to affect the application of "pick up" contributions to purchase permissive service credit or the treatment of pick up contributions under IRC section 415. The provision does not apply to purchases of service credit for qualified military service under the rules relating to veterans' reemployment rights.

The **TRA of 1997** provides a transition rule for plans that provided for the purchase of permissive service credit prior to enactment of the TRA of 1997. Under this rule, the defined contribution limits will not reduce the amount of permissive service credit of an eligible participant allowed under the terms of the plan as in effect on the date of enactment. For this purpose an eligible participant is an individual who first became a participant in the plan before the first plan year beginning after the last day of the calendar year in which the next regular session (following the date of the enactment of TRA of 1997) of the governing body with authority to amend the plan ends.

Removal of Dollar Limitation on Benefit Payments from a Defined Benefit Plan for Police and Fire Employees - Under **present and prior law**, limits are imposed on the contributions and benefits under qualified pension plans. Certain special rules apply in the case of state and local governmental plans.

In the case of a defined benefit pension plan, the limit on the annual retirement benefit is the lesser of (1) 100% of compensation or (2) $125,000 (for 1997, indexed for inflation). The 100% of compensation limitation does not apply in the case of state and local governmental pension plans. In general, the dollar limit is reduced if benefits begin before social security retirement age and increased if benefits begin after social security retirement age. In the case of state and local governmental plans, the dollar limit is not reduced unless benefits begin before age 62 and in any case is not less than $75,000, and the dollar limit is increased if benefits begin after age 65. Under **prior law**, this rule applied to police and fire department employees, except that the dollar limit could not be reduced below $50,000 (indexed), regardless of the age at which benefits commenced. This special rule applied to participants (1) in a defined benefit plan of a state or local governmental plan, and (2) with respect to whom the period of service taken into account in determining the amount of the benefit under such plan includes at least 15 years of service of the participant as (a) a full-time employee of a police or fire department organized by a state or political subdivision to provide police protection, firefighting services, or emergency medical services or (b) as a member of the Armed Services of the United States.

Under the **TRA of 1997**, the dollar limit on defined benefit plans does not apply to the reduction for early retirement benefits for individuals who received the special rule for certain police and fire department employees under **prior law**. Thus, the defined benefit plan dollar limit continues to apply, but is not reduced in the case of early retirement. As under present law, the dollar limit is increased for such employees if benefits begin after age 65.

Gratuitous Transfers for the Benefit of Employees - Under **present and prior** law, an ESOP is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan under which employer securities are held for the benefit of employees.

Under **present and prior law**, a deduction is allowed for federal estate tax purposes for transfers by a decedent to charitable, religious, scientific, etc. organizations. In the case of a transfer of a remainder interest to a charity, the remainder interest must be in a charitable remainder trust. A charitable remainder trust generally is a trust that is required to pay, no less often than annually, a fixed dollar amount (charitable remainder annuity trust) or a fixed percentage of the fair market value of the trust's assets determined at least annually (charitable remainder unitrust) to noncharitable beneficiaries, and, under **prior law**, the remainder of the trust (i.e., after termination of the annuity or unitrust amounts) to a charitable, religious, scientific, etc. organization.

The **TRA of 1997** permits certain limited transfers of qualified employer securities by charitable remainder trusts to ESOPs without adversely affecting the status of the charitable remainder trusts under IRC section 664. As a result, the TRA of 1997 provides that a qualified gratuitous transfer of employer securities to an ESOP is deductible from the gross estate of a decedent under IRC section 2055 to the extent of the present value of the remainder interest. In addition, an ESOP will not fail to be a qualified plan because it complies with the requirements with respect to a qualified gratuitous transfer.

In order for a transfer of securities to be a "qualified gratuitous transfer," the following requirements must be satisfied: (1) the securities transferred to the ESOP must previously have passed from the decedent to a charitable remainder trust; (2) at the time of the transfer to the ESOP, family members of the decedent own (directly or indirectly) no more than 10% of the value of the outstanding stock of the company; (3) immediately after the transfer to the ESOP, the ESOP owns at least 60% of the value of outstanding stock of the company (the 60% requirement is determined assuming that outstanding options have been exercised); and (4) the plan meets certain requirements. In order to prevent erosion of the 60% ownership requirements, an excise tax is imposed on the employer maintaining the ESOP with respect to certain dispositions of the transferred stock within three years of the transfer.

In order for a transfer to qualify as a gratuitous transfer, the ESOP must contain certain provisions. First, the plan must provide that plan participants are entitled to direct the manner in which stock transferred are to be voted (with respect to all matters). Transferred securities that have not yet been allocated to participants must be voted by a trustee that is not a 5% owner of the company or a family member of the decedent.

Second, the plan must provide that participants have the right to receive distributions in the form of stock and that the participant can require the employer to repurchase any shares distributed under a fair valuation formula. For this purpose, a valuation formula is not considered fair if it takes into account a discount for minority interests.

Finally, the plan must provide that, if the plan is terminated before all the transferred stock has been allocated, the remaining stock is to be transferred to one or more charitable organizations. The employer is subject to an excise tax designed to recapture the estate taxes that would have been due had the transfer to the ESOP not occurred if the plan is terminated and any unallocated shares are not transferred to charitable organizations.

No deduction is permitted under IRC section 404 with respect to securities transferred from the charitable remainder trust. The nondiscrimination requirements normally applicable to qualified plans must be satisfied with respect to the securities transferred. The ESOP is required to treat the securities transferred as employer securities, except for purposes of determining the amount of deductible contributions to the plan otherwise permitted by the employer. The ESOP is required to allocate the transferred securities up to the limit on contributions and benefits after allocating any other employer contributions for the year; any transferred securities that cannot be allocated because of the IRC section 415 limits would be held in a suspense account and allocated in the same manner in subsequent years. Transferred securities are not taken into account in determining whether any other contributions satisfy the IRC section 415 limit. Further, securities transferred to an ESOP by a charitable remainder trust cannot be allocated to the account of (1) any family member of the decedent, or (2) any employee owning more than 5% of any class of outstanding stock of the corporation issuing the securities (or a member of a controlled group of corporations) or the total value of any class of outstanding stock of any such corporation. The employer is subject to an excise tax if impermissible allocations are made.

Qualified employer securities include only employer securities (within the meaning of IRC section 409(l) which are issued by a domestic corporation that has no outstanding stock that is readily tradable on an established securities market and that has only one class of stock.

Except for tax rates and the imposition of some excise taxes **California law** is in full conformity with the various pension provisions described above as of January 1, 1997.

This bill would conform California law to the TRA of 1997 federal changes as relating to pensions and other benefits described above.

62. <u>Modification to Minimum Tax Depreciation Rules.</u>

Under **federal law**, a taxpayer is subject to an alternative taxable income (AMT) to the extent that the taxpayer’s tentative minimum tax exceeds the taxpayer’s regular income tax liability. A taxpayer's tentative minimum tax generally equals 20 percent (24 percent in the case of an individual) of the taxpayer's alternative minimum taxable income (AMTI) in excess of an exemption amount. AMTI is the taxpayer's taxable income increased by certain tax preference items and adjusted by determining the tax treatment of certain items in a manner which negates the deferral of income resulting from the regular tax treatment of those items.

For taxable years beginning after 1989, the AMTI of a corporation is increased by an amount equal to 75% of the amount by which adjusted current earnings (ACE) of the corporation exceed AMTI (as determined before this adjustment). In general, ACE is AMTI with additional adjustments that generally follow the rules presently applicable to corporations in computing their earnings and profits. Under **prior federal law**, for purposes of ACE, depreciation was computed using the straight-line method over the class life of the property. Thus, prior to 1994, a corporation generally made two depreciation calculations for purposes of the AMT -- once using the 150% declining balance method over the class life (see Item 7, page 15 above) and again using the straight-line method over the class life. Taxpayers may elect to use either method for regular tax purposes. If a taxpayer uses the straight-line method for regular tax purposes, it must also use the straight-line method for AMT purposes.

Present federal law, as amended by the the Revenue Reconciliation Act of 1993 eliminated the depreciation component of the ACE adjustment for corporations. Thus generally, in conjunction with the TRA of 1997, depreciation is no longer an adjustment or preference item for AMT purposes.

The **B&CTL** is generally conformed to federal rules with respect to the amount allowable in computing alternative minimum taxable income. California law still requires corporate taxpayers to compute the depreciation component of the ACE adjustment.

Under current **California law**, an adjustment is required to be made for the difference between the amount allowed as depreciation calculated under the useful life of the assets for regular tax and the amount allowed as depreciation calculated under the useful life of the assets for AMT purposes. This bill would eliminate this adjustment as outlined in Item 7 above. Although the federal rules apply for determining the amount allowable for AMT purposes, the amount of the actual adjustment may be different due to differences (past and present) in state and federal rules for computing depreciation for regular tax purposes.

The **B&CTL** is conformed, with certain modifications, to federal rules for computing depreciation for purposes of making the ACE adjustment:

1. Property placed in service on or after January 1, 1990.

   The amount allowed as a state deduction in computing "adjusted current earnings" is computed under IRC section 168(g) which, in general, requires use of the straight-line depreciation method over the recovery period applicable to that property. Although the federal rules apply for determining the amount of depreciation allowed, the amount of the actual adjustment may be different due to differences in state and federal rules for computing depreciation for regular tax purposes.

2. Property placed in service on or after January 1, 1987, and prior to January 1, 1990.

The amount allowed as a state deduction in computing "adjusted current earnings" is the amount that would have been allowed if the taxpayer depreciated the remaining adjusted basis of the property (under AMT rules), as of January 1, 1990, using the straight-line method over the remainder of the recovery period applicable to that property under the alternative system of IRC section 168(g). Although the federal rules apply for determining the amount of depreciation allowed, the amount of the actual adjustment may be different due to differences in state and federal rules for computing depreciation for regular tax purposes.

3. Property placed in service on or after January 1, 1981, and before January 1, 1987.

Generally, the amount allowable for computing "adjusted current earnings" is the amount that would have been allowed if the taxpayer depreciated the property under the straight-line method for each year of the "useful life" of the property.

4. Property placed in service prior to January 1, 1981.

The amount allowed as a state deduction in computing "adjusted current earnings" is the same amount that was computed for state regular tax purposes.

This bill would conform California law to the Revenue Reconciliation Act of 1993 elimination of the depreciation component of the ACE adjustment for corporations.

63. Technical Changes.

This bill makes 74 other changes to the Revenue and Taxation Code of which 36 are classified as “clean-up” provisions and 38 are classified as technical changes (14 state and 24 federal.)

Twenty-nine of the 36 “clean-up” provisions consist of removing stand alone language required to conform to various provisions of the TRA of 1997 prior to this bill. Because this bill is changing the “specified date” from January 1, 1997 to January 1, 1998, various sections added or modified by prior specific item conformity would no longer be needed. Because California has previously conformed to these federal provisions by reference, changing the specified date would automatically conform to the TRA of 1997 change.

The seven remaining “clean-up” items contained in this bill would preserve the state and federal difference. If a federal provision was previously conformed to by reference, changing the specified date would automatically conform to the federal change unless state language is enacted to preserve the nonconformity to the TRA of 1997 change, This bill contains language that would not conform to the following TRA of 1997 changes:

1. Change in maximum capital gains rate for individuals.
2. Assignment of worker's compensation liability eligible for exclusion relating to personal injury liability assignments.
3. Simplified flow-through for electing large partnerships.
4. Exemption from AMT for small corporations.
5. Modification of taxable years to which net operating losses may be carried.
6. Returns required on magnetic tape.
7. Exclusion from unrelated business taxable income for certain sponsorship payments.

The technical changes generally correct typos, cross-references, and clarify existing law and definitions.

FISCAL IMPACT

Departmental Costs

Tax Revenue Estimate

Tax revenue losses of $15 million, $29 million and $32 million for fiscal years 1998-99, 1999-00, and 2000-01, respectively.

The following table reflects the estimated impacts of the various provisions of this bill:

		Personal Income Tax			Bank & Corporation Tax		
		(In millions)			(In millions)		
	Description	**1998-9**	**1999-0**	**2000-1**	**1998-9**	**1999-0**	**2000-1**
1	Medicare Plus Choice distributions	(neg.impact)	(neg.impact)	(neg.impact)	-----	-----	-----
2	Hospitals participating in provider-sponsored organizations	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----
3	Deduction for student loan interest	($14)	($15)	($16)	-----	-----	-----
4	Qualified state tuition programs	No Revenue Impact			-----	-----	-----
5	Contributions of computer equipment to schools	-----	-----	-----	($4)	($4)	($4)
6	Cancellation of certain student loans	(minor loss)	(minor loss)	(minor loss)	-----	-----	-----
7	Repeal depreciation adjustment for AMT	($1)	($5)	($8)	(minor loss)	($1)	($1)
8	Repeal of throwback rules	-----	-----	-----	(minor loss)	(minor loss)	(minor loss)
9	Home office deduction	($3)	($8)	($9)	-----	-----	-----
10	Expensing of environmental remediation costs	($1)	($1)	(minor loss)	($6)	($5)	($2)
11	Shrinkage estimates for inventory accounting	(minor loss)	(minor loss)	(minor loss)	($1)	($1)	($1)
12	Timeshare associations	-----	-----	-----	(neg. loss)	(neg. loss)	(neg. loss)
13	Increased deduction of business meals for DOT employees	($1)	($1)	($1)	-----	-----	-----
14	Deductibility of meals provided for convenience of employer	Included in Section 969			-----	-----	-----
15	Modify limits on depreciation of luxury automobiles	-----	-----	-----	(neg. loss)	(neg. loss)	(neg. loss)
16	Suspension of income limit on percentage depletion	-----	-----	-----	($2)	($1)	(minor loss)
17	Mileage deduction for charitable use of auto	($2)	($2)	($2)	-----	-----	-----
18	Receivables purchased by coop hospitals	-----	-----	-----	(neg. loss)	(neg. loss)	(neg. loss)
19	Provide above-the-line deduction for certain business expenses	($1)	(minor loss)	(minor loss)	-----	-----	-----
20	Recognition of gain on certain appreciated financial positions a/	-----	-----	-----	-----	-----	-----
21	Mark-to-market election	Included in #20 above			-----	-----	-----
22	Limitation on exception for investment companies under sec 351	Included in #20 above			-----	-----	-----
23	Gains/losses on terminations of property	-----	-----	-----	$1	$1	$1
24	OID on pooled debt obligations	-----	-----	-----	$10	$11	$11
25	Deny interest deduction on certain debt instruments b/	-----	-----	-----	-----	-----	-----
26	Require gain recognition for certain extraordinary dividends	-----	-----	-----	$10	$2	$2
27	Require gain recognition on certain distributions of controlled stock c/	-----	-----	-----	(minor gain)	(minor gain)	(minor gain)
28	Reform tax treatment of certain corporate stock transfers	-----	-----	-----	(minor gain)	(minor gain)	(minor gain)
29	Treat certain preferred stock as "boot"	-----	-----	-----	$2	$1	$1
30	Holding period for dividends received deduction	-----	-----	-----	(minor gain)	(minor gain)	(minor gain)
31	Reporting of certain payments made to attorneys d/	-----	-----	-----	-----	-----	-----
32	Beneficiaries of estates and trusts returns	(neg. gain)	(neg. gain)	(neg. gain)	-----	-----	-----
33	Registration of confidential corporate tax shelters	-----	-----	-----	$1	$1	$1
34	Extend UBIT rules to second-tier subs and amend control test	-----	-----	-----	(minor gain)	(minor gain)	(minor gain)
35	Basis allocation for partnership property distributions	$3	$2	$2	(minor gain)	(minor gain)	(minor gain)
36	Appreciation of inventory when partnership interest sold	(minor gain)	(minor gain)	(minor gain)	(neg. gain)	(neg. gain)	(neg. gain)
37	Extension of time for taxing precontribution gain				Included in Section 1062		
38	Cashout of certain accrued benefits e/	-----	-----	-----	-----	-----	-----
39	Cash in lieu of parking benefits f/	-----	-----	-----	-----	-----	-----
40	Basis recovery rules on annuities	(minor gain)	(minor gain)	(minor gain)	-----	-----	-----
41	Denial of certain amounts paid in connection with insurance	-----	-----	-----	$3	$4	$5
42	Limits on property using income forecast method g/	-----	-----	-----	-----	-----	-----
43	Replacement of involuntarily converted property	(minor gain)	(minor gain)	(minor gain)	-----	-----	-----
44	Exceptions to installment sales rules	-----	-----	-----	$4	$4	$4
45	Charitable remainder trust eligibility	-----	-----	-----	(neg. gain)	(neg. gain)	(neg. gain)
46	Estimated tax safe harbor rules (accelerated payments)	($4)	($1)	($1)	-----	-----	-----
47	Personal transactions & foreign currency gain	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----
48	Simplify formation and operation of international joint ventures	-----	-----	-----	(minor gain)	(minor gain)	(minor gain)
49	Eliminate AMT for children under 14	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----
50	Amount of tax exempt from estimated tax rules (delayed payments) h/	($1)	(minor loss)	(minor loss)	-----	-----	-----
51	Reimbursed expenses of rural mail carriers	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----
52	Travel expenses of Federal employees	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----

53	Look-back method for long-term leases	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)
54	Construction allowances for short-term leases	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)
55	Close of partnership year & deceased partners	(neg. gain)	(neg. gain)	(neg. gain)	(neg. gain)	(neg. gain)	(neg. gain)
56	Reasonable cause exception for penalties	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)
57	Statute of limitations on assessments	No Revenue Impact					
58	Estate tax provisions	(neg .loss)	(neg .loss)	(neg .loss)	-----	-----	-----
59	Interest on large corp. underpayments	-----	-----	-----	(neg. loss)	(neg. loss)	(neg. loss)
60	Pension simplification provisions	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----
61	Miscellaneous provisions relating to pensions and other benefits	($2)	($2)	($2)	($1)	($1)	($1)
62	Eliminate ACE adjustment for AMT	-----	-----	-----	($5)	($7)	($11)
	TOTALS	($27)	($33)	($37)	$12	$4	$5
	Negligible = Loss or gain of less than $250,000						
	Minor = Loss or gain of less than $500,000						
a/	(#20) Baseline revenue gains of $10 million for 1997-8, $4 million for 1998-9, and $2 million annually thereafter will automatically occur.						
b/	(#25) Baseline rev. gains of $1 mil. annually will automatically occur as taxpayers structure debt instruments in response to the fed. law change.						
c/	(#27) Baseline revenue gains of $7 million beginning in 1997-8 will also occur.						
d/	(#31) Negligible baseline revenue gains annually beginning in 1998-9 will automatically occur.						
e/	(#38) Baseline revenue gains of less than $500,000 annually beginning in 1997-8 will occur automatically for state tax purposes.						
f/	(#39) Baseline revenue gains of less than $500,000 annually beginning in 1997-8 will occur automatically for state tax purposes.						
g/	(#42) Baseline revenue gains of less than $500,000 annually beginning in 1997-8 will occur automatically for state tax purposes.						
h/	(#50) This impact reflects increasing the estimated tax requirements to double the current law ($100 to $200 for married filing joint)						
	as proposed to be amended.						

BOARD POSITION

Pending.

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Telephone # 845-5322
Attorney Doug Bramhall

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1496
As Amended April 20, 1998

AMENDMENT 1

Page 78, line 24, strikeout " one thousand dollars ($1,000)" and insert:

two hundred dollars ($200)

AMENDMENT 2

Page 78, line 27, strikeout "Five hundred dollars ($500)" and insert:

one hundred dollars ($100)